CHAPTER 3

Outlook and Policy

IN THE SUMMER OF 1971 the American economy was beset by a conflict among four objectives—faster growth, higher employment, greater price stability, and a more balanced external position. The danger was that steps to speed up growth and boost employment by expanding demand would worsen both the inflation and the balance-of-payments deficit.

The steps initiated on August 15 greatly increased the possibility of simultaneous progress on all four fronts. The price and wage control system has provided more room for expanding growth and employment even while inflation and inflationary expectations are being reduced. The realignment of exchange rates promises an improvement of the U.S. external position even while the domestic economy is expanding. The measures taken last year did not *eliminate* potential conflicts among these goals. Expansive measures must still be moderated by concern with both inflation and the balance of payments. But the area of consistency among the objectives has been greatly widened.

At the end of 1971 we were already seeing more rapid growth of output and employment and a lower rate of inflation. During 1972 we expect continued economic expansion which will reduce the unemployment rate significantly. The lower rate of inflation should be more durable by the end of 1972, after a longer period of greater price stability. Progress should have been made toward a stronger external position.

The U.S. economy will expand substantially in 1972. All major components of domestic demand will increase and the aggregate demand for goods and services will rise by about $100 billion to around $1,145 billion. This is an increase of 9½ percent over the level of GNP in 1971. The real increase will be around 6 percent while the implied increase in the GNP price deflator is around 3¼ percent. This is compatible with the interim objective of an inflation rate of 2 to 3 percent by the end of 1972.

There are several reasons for expecting that the forecast pace of expansion will be realized. In the fourth quarter of 1971 real output had already begun to rise much more rapidly than in the 2 preceding quarters. Except for a decline in net exports all sectors of demand rose in the fourth quarter.

A second reason is that fiscal and monetary policy has become more expansionary. Third, the existence of price and wage controls will reduce the pressure both of inflation and of inflationary expectations. This permits fiscal and monetary policy to exert a more expansive thrust than was prudent earlier when the inflation objective was more vulnerable. It has also strengthened consumer confidence and should strengthen consumer spending.

DEVELOPMENTS IN THE FOURTH QUARTER OF 1971

Preliminary data show that GNP rose by about $20 billion in the fourth quarter of 1971, or at an annual rate of 7.7 percent. Most prices were subject to the freeze during the first half of the quarter and to Phase II controls thereafter, and the GNP price deflator rose at the very low rate of 1.5 percent per annum. Real GNP expanded at an annual rate of 6.1 percent. Manufacturing production, which had declined from May to August, rose from the third quarter to the fourth at a seasonally adjusted annual rate of 5.5 percent.

Rises in real economic activity were accompanied by strong increases in employment and productivity. Civilian nonagricultural employment rose more than 700,000 from the third to the fourth quarter, the average workweek lengthened by 0.3 hours and, in the private nonfarm sector, output per man-hour rose at an annual rate of nearly 5 percent. As a result of the strong productivity gain, unit labor costs showed their smallest increase since late 1965. Because the rise in the labor force was very large, the unemployment rate was virtually unchanged.

Government purchases of goods and services accounted for $7 billion of the total $20 billion rise in demand in the fourth quarter. Of this, $3 billion represented a rise in Federal purchases. This was the largest increase in Federal purchases since the first quarter of 1967; it was attributable to larger defense outlays, partly to cover the volunteer army program, and to increased outlays for agricultural price supports.

Investment expenditures also rose in the fourth quarter. Fleet sales of cars were very strong, as were purchases of trucks. New orders for producers' capital equipment averaged 4½ percent higher during September to November than in the 3 preceding months. Housing production in the fourth quarter continued to show great strength; starts in December reached a seasonally adjusted annual rate of 2.5 million units, bringing the average rate for the quarter to 2.3 million units. Investment in business inventories, which had declined by $1 billion in the preceding quarter, rose by $2 billion.

The New Economic Policy induced a sharp rise in automobile sales. Prior to the August 15 announcement, sales of domestic-type new cars were running at a seasonally adjusted annual rate of about 8 million units. In September, sales rose to a rate of 10.8 million and in October to 10.0 million; the rate fell noticeably after mid-November when the price freeze ended. For the fourth quarter as a whole, sales were not greatly different from the third quarter rate, but the rate from September through December was 17 percent higher than the average for the 3 months immediately preceding the NEP. Some of the early rise was at the expense of foreign car sales and subsequent domestic sales.

The outlook for each of the major components of expenditures on GNP in 1972 is discussed below.

Business Fixed Investment

Business fixed investment in 1972 will rise significantly for the first time since 1969. The Department of Commerce-SEC survey taken in November and December indicates plans for a 9-percent increase over 1971 in outlays for new plant and equipment. The survey shows stronger than average spending intentions for nonmanufacturing firms, especially airlines, electric and gas utilities, and communications companies. For the nonmanufacturing segment as a whole the anticipations data show that capital outlays will rise by 12 percent in 1972. However, the manufacturing sector, which was utilizing capacity at a relatively low level in the fourth quarter, expects capital outlays in 1972 to be only 4 percent above the 1971 level.

Business should have little difficulty in financing this year's planned investment. With rising output, aggregate profits are expected to show a sizable advance and retained earnings should rise significantly. The revised regulations on depreciation and the 7-percent job development credit will increase after-tax corporate cash flow by an additional $2.5 billion.

Those components of business fixed investment not included in the plant and equipment survey are likely to rise as well, but at a lower rate than capital outlays included in the Commerce-SEC survey. The overall increase in total business fixed investment is estimated to be around 8 percent on a year-to-year basis.

Inventory Investment

The level of business inventories has changed relatively little over the past 2 years and the ratio of stocks to sales has fallen. Although inventories held by wholesalers were on the high side in late 1971, inventories held by manufacturers and retailers were lower relative to sales than at any time since the fall of 1968. With favorable sales prospects following the sizable increase in real output in the fourth quarter, business investment in inventories should show a strong increase in 1972. The expected expansion of defense-related ordering should also add to the demand for inventories. Inventory accumulation for the year as a whole is expected to be around $8 billion.

Residential Construction

The total number of private housing starts in 1972 is expected to be 2.2 million units. Within this total, single-family units are expected to be much stronger than starts of multifamily units. This shift from multifamily to single-family units will strengthen total residential outlays in 1972, which are expected to exceed 1971 by 15 percent or more.

In early 1972 market interest rates continued the declines which began in 1971 and financial intermediaries continued to enjoy heavy inflows of new deposits. These developments provided increased funds for home mortgages and induced a decline in mortgage interest rates. The outlook for the remainder of 1972 is that the availability and cost of mortgage funds will remain at levels that would be unlikely to limit the expansion forecast for the housing sector.

The Federal National Mortgage Association (FNMA) and the Federal Home Loan Mortgage Corporation will continue their mortgage purchase programs and secondary market activities, and the Government National Mortgage Association (GNMA) will continue guaranteeing mortgage-backed pass-through securities and standard mortgage-backed bonds. At present, GNMA's insured-mortgage market support operation in conjunction with FNMA is not operating because mortgage market rates have declined relative to the FHA ceiling rate. If these conditions change, the coordinated FNMA–GNMA purchase plan will be automatically resumed, with likely support from other Federal agencies as well.

Net Exports

In 1971 U.S. net exports of goods and services declined from a level of $4.7 billion in the first quarter to minus $2.0 billion in the final quarter of the year. The outlook for net exports in 1972 is subject to a wider margin of uncertainty than usual. Underlying factors point to a rise in net exports within the year. The substantial realignment of the dollar's exchange rate relative to other major currencies will improve the relative competitive position of U.S. goods and services. The abatement of inflation in the United States and the increase in productivity that is expected will reinforce the effects of realignment. While the influence of these positive factors is clear, both the magnitude and timing of the improvement they will bring are difficult to specify. In addition there are two short-run factors in 1972 which can be expected to affect net exports adversely. The U.S. economy will be expanding faster than it has in several years. At the same time the rate of expansion in several major markets abroad will be relatively low. Also, the initial effects of currency realignment may actually be perverse because import contracts predating the change will entail higher dollar outlays. Because of these factors, it will be some months before U.S. net exports of goods and services are positive once again. The average for the year as a whole will probably be close to zero.

Government Purchases of Goods and Services

Government purchases at all levels will constitute a highly expansive force for economic activity in 1972. Total purchases are expected to rise 11 percent, with Federal purchases increasing by 9 percent and State and local purchases by 12 percent. The increase in State and local purchases reflects the proposed revenue-sharing program of the Federal Government and the continuing favorable conditions in credit markets.

Federal expenditures are discussed in more detail in the subsequent section on fiscal policy.

Personal Consumption Expenditures

The expectations just outlined show that the demand for GNP, other than consumption, in the aggregate will rise by around 12 percent between 1971 and 1972. Such a rise by itself should produce significant increases in employment. In spite of the slower rate of increase in wage rates expected as a result of wage and price controls, total payrolls will also increase significantly. The growth in earned income will be augmented by increases in Social Security benefits. In addition, as a result of the high rate of personal saving during the past 2 years, the financial position of consumers as measured by their liquid asset holdings is extremely strong. The impact of these financial factors on consumer expenditures will, of course, depend on changes in the level of consumer confidence.

In 1971 consumers increased their spending by 7.5 percent over 1970. They also maintained their rate of saving out of disposable income in the neighborhood of 8 percent. The ratio of saving to disposable income observed in these 2 years is significantly higher than the 6 percent rate for the period 1960 to 1969. While this might represent a shift in consumer preferences for, say, liquid assets, it has also been interpreted by some as being due, at least in part, to the confidence factor, which tends to decline when the rate of unemployment and the pace of inflation are high.

There is already evidence that consumer confidence has improved since last summer. The expectation is that it will improve further as employment increases and the rates of unemployment and inflation decline. If the reasoning which relates the saving rate to the confidence factor is correct, consumer spending will rise at a faster rate than the rise in disposable income. However, the forecast for consumer spending projected in this *Report* does not assume that consumers in 1972 will reduce the high rate of saving that prevailed in 1970 and 1971. In the first place, clear evidence of a sustained drop in the saving rate is not yet available. Second, the tax cuts which consumers will enjoy in the first half of 1972 and the increase in transfer payments scheduled for midyear will tend to keep the saving rate high because the response of spending to such increases in income is typically delayed.

Consumer spending is expected to rise by around 8 percent in 1972. Together with the forecast for nonconsumption expenditures the total expected rise in GNP adds to about $100 billion.

Fiscal and Monetary Policy

Fiscal policy will make a major contribution to the achievement of an expansive economy in 1972. Federal expenditures on the national income accounts (NIA) basis are expected to total $251 billion in calendar 1972, a rise of $29 billion, or 13 percent over calendar 1971. A substantial part of the rise will occur during the first half of calendar 1972.

Federal purchases of goods and services, which had been declining gradually since 1968, have already begun to rise. The larger purchase figures reflect previously announced increases in military pay, the Federal pay increase in January 1972, and additional increases in purchases. The rise in defense purchases would reverse a fairly steady trend from the fourth quarter of 1968 to the third quarter of 1971, during which the rate of defense spending measured in current dollars declined by about 12 percent and in constant dollars, 27 percent. These expenditures are scheduled to rise in 1972. In addition, there is a sharp increase in Federal grants to State and local governments, which reflects the new revenue-sharing proposals of the Administration as well as proposed increases in welfare grants to States.

Tax cuts will also provide considerable stimulus in 1972. From calendar 1971 to 1972 the net reduction in tax receipts due to changes in tax laws and regulations is estimated at $3.7 billion on an NIA basis. The tax reductions are estimated at $8.9 billion, but these are partly offset by increases in the social security base starting in January 1972. Most of the economic impact of these social security tax increases will not be realized until the second half of 1972; consequently, these tax increases should not depress consumer spending significantly in 1972.

In both 1971 and 1972 receipts are considerably less than expenditures, primarily because the economy in these years is below its full potential. For calendar 1972 NIA receipts are estimated to be $215 billion and NIA expenditures $251 billion. Thus, the projected deficit for calendar year 1972 is $36 billion on an NIA basis compared to $23 billion in 1971. This expansion of the deficit as computed on the forecast path for the economy indicates that the 1972 fiscal policy is stimulative. The faster rise of expenditures than receipts will increase demand either by direct government purchases or by bolstering private incomes and private demand. The unified budget, measured on a full-employment basis, moves from a surplus of $4.9 billion in fiscal year 1971 to a deficit of $8.1 billion in fiscal 1972. The budget on the same basis returns to balance in fiscal year 1973.

The steady, strong expansion we seek and expect will require support from monetary policy. An abundant supply of money and other liquid assets, and favorable conditions in money markets, should encourage an expansion of outlays by consumers, businesses, and State and local governments. This process would involve a more rapid rise of currency and demand deposits than occurred in the second half of 1971. Steps have already been taken by the Federal Reserve System to start this acceleration.

Major Uncertainties

The Council's projection for aggregate demand for 1972 falls within the fairly narrow range of projections made by private organizations and individuals. Nonetheless, there are important uncertainties which could produce a level of economic activity either higher or lower than the level forecast.

The plans for fiscal expansion require action by Congress, which might be slower in coming than has been assumed. Expansive policies can be thwarted if consumers decide to increase their already high saving rate. The expected adjustment of U.S. net exports might involve a longer lag than we have posited. The change in business inventory policy may not turn out to be as substantial or as rapid as the path assumed in the forecast.

On the other side there is a good possibility that consumers will increase their rate of spending faster than the projected rise in disposable income. This would have important secondary benefits in other sectors—notably in business investment outlays and business demands for inventory.

GNP forecasts made by the Council have been qualified in the past by the caveat that they should be viewed as the midpoint of a range of plus or minus $5 billion around the forecast. When GNP was $500 billion, this was the equivalent of a band of uncertainty of ±1 percent. The equivalent band of uncertainty for today's larger numbers would be ±$10 billion.

PRICES AND PRICE-WAGE POLICY

The rate of inflation in 1972 (as measured by the GNP price deflator) is expected to fall to about 3¼ percent, the lowest year-to-year change since 1967. Toward the end of the year the rate of price change is expected to be 2–3 percent per annum.

The estimate made here of the rate of inflation during 1972 assumes two things. First, it assumes a growth of money demand that is strong and steady but not so exuberant that significant shortages of products or labor would be created if price and wage increases were held to the forecast path. Second, it assumes that the price-wage control system, given such demand conditions, will be of the character, force, and duration needed to maintain that path.

The Administration's policy is to create and maintain both of these conditions. Earlier in this chapter we have described the demand conditions we foresee for 1972 and the fiscal and monetary policies expected to help bring them about. In Chapter 2 we described the existing state of the price-wage control system. We expressed the view there that the existing system of standards and procedures is consistent with the achievement of the anti-inflationary goals the Administration has laid out, barring difficulties not now foreseen. The important point, however, is that the system will be adapted as necessary to achieve the goal.

The control system will be retained as long as is necessary to reach its goal—which is a condition of the economy in which we can have a significantly lower rate of inflation without controls than we were experiencing in the first part of 1971. Speculation that the Administration will abandon the controls prematurely—out of fatigue, ideological aversion, or other causes—is groundless. Having embarked upon this course the Administration has no intention of departing from it in circumstances where it would risk either resumption of inflation or the need to reimpose the controls.

The basic premise of the price-wage control system is that the inflation of 1970 and 1971 was the result of expectations, contracts, and patterns of behavior built up during the earlier period, beginning in 1965, when there was an inflationary excess of demand. Since there is no longer an excess of demand, the rate of inflation will subside permanently when this residue of the previous excess is removed. The purpose of the control system is to give the country a period of enforced stability in which expectations, contracts, and behavior will become adapted to the fact that rapid inflation is no longer the prospective condition of American life. When that happens controls can be eliminated.

How long that will take no one can say. The conditions now existing and the policies in operation are unprecedented. The only sensible course is to observe the behavior of the economy closely and to avoid commitment to either a minimum or a maximum duration of controls.

During the control period there will be decisions to exclude from coverage one or another sector of the economy, as has recently been done for retail stores with less than $100,000 annual sales and single-family houses and apartments with two to four units under certain conditions. Such exclusions should not be interpreted as signs of the weakening of the system or portents of its early termination. They may, in fact, make the system stronger and more durable by permitting the administrative effort to be concentrated on the sectors most significant for inflation. This is especially true when, as is often the case, price increases in the excluded sector would be effectively limited by competition from the parts of the economy that remain under legal control.

EMPLOYMENT AND UNEMPLOYMENT

Our estimate implies an increase of 6 percent in real GNP between 1971 and 1972. This is about the rate of increase achieved in the fourth quarter of 1971.

There is no easy way to separate the forecast rate of real growth into employment and productivity gains. Clearly, it should yield substantial increases in both. The extent to which the employment gains will reduce the unemployment rate depends on the size of the increase in the labor force. It is estimated that the unemployment rate should decline from the 6 percent level of December 1971 to the neighborhood of 5 percent by the end of 1972.

Reduction of the unemployment rate in 1972 is a primary objective of this year's economic policy. It is to this end that the Government is pursuing a highly expansive fiscal policy. And it is in large part to this end that prices and wages are controlled, so that the expansion of demand will generate more jobs, not more inflation.

Concern with unemployment is also the primary motivation behind a large variety of other Government efforts, more specialized in their impact but nevertheless critical for achieving full employment. Many of these are now focused on the problems arising in the transition from high levels of military and civilian employment in national defense.

The number of male Vietnam era veterans in the civilian population has increased by over 1.3 million over the last 2 years (Table 24). In June 1971, the President launched a new program designed to aid veterans in the job market. As part of this coordinated program, Project Transition, a pre-discharge counseling, training, and placement program, was expanded and extended overseas. Training opportunities for veterans under existing manpower programs were increased, additional veterans' employment counselors (many of them veterans) were added to the Employment Service and, perhaps most importantly, a new regulation which requires all Federal contractors to list job openings with the Employment Service should provide veterans with opportunities to apply for a much wider selection of jobs. A coordinated effort was also launched in the private sector. During the year over 100 Job Fairs, which bring veterans and potential employers together, were sponsored by the Jobs for Veterans Committee in cooperation with the National Alliance of Businessmen, which also plans to place 100,000 veterans in jobs by June 1972. These efforts resulted in an estimated 320,000 direct job placements between June and October. Civilian employment of Vietnam era veterans rose by 500,000 over the year (Table 24).

When unemployment is high, the development of additional jobs in areas of unmet public needs is possible and desirable. Initiation of the Public Employment program, which was authorized by the Emergency Employment Act of 1971, was a major step forward in this area. This Federal program, which temporarily subsidizes most of the cost of adding new employees

TABLE 24.—*Employment status of male Vietnam era veterans and nonveterans 20–29 years of age, fourth quarter, 1969–71*

[Thousands of persons except as noted]

Group	1969 IV	1970 IV	1971 IV
Veterans:			
Civilian population	2,990	3,696	4,293
Labor force	2,752	3,383	3,931
Employment	2,621	3,115	3,626
Unemployment	130	269	305
Unemployment rate (percent)	4.7	8.0	7.8
Nonveterans:			
Civilian population	8,589	9,068	9,567
Labor force	7,334	7,810	8,200
Employment	7,089	7,281	7,633
Unemployment	245	529	567
Unemployment rate (percent)	3.3	6.8	6.9

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

Source: Department of Labor.

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to State and local government payrolls, is designed both to meet the need for improved public services and to provide transitional career employment opportunities for jobless workers, especially veterans and the disadvantaged. At year's end, funds had been provided for about 128,000 positions, and about three-fifths of the jobs had been filled.

Retraining and job-finding services for engineers, scientists, and technicians, previously employed in defense or space efforts were greatly increased in 1970–71 under the new Technology Mobilization and Reemployment program and related programs. These will be expanded further in 1972.

The realignment of defense expenditures after 1968 has had substantial adverse impact on some communities whose economies depend on defense-related activities. The Federal Government operates a continuing community aid program, which is under the jurisdiction of the Inter-Agency Economic Adjustment Committee (chaired by the Secretary of Defense and comprised of policy-level personnel drawn from all major domestic agencies). The Committee's mission is to provide organized aid in the transition from a defense-based local economy to a balanced local economy. To carry out its responsibilities, the Committee ensures that all Federal Government services and facilities are focused on viable economic adjustment plans designed in the local communities. On various occasions, the Committee working through a local community task force has aided in the adjustment process by the transfer of surplus Federal property, initiation or expansion of manpower training programs and related social services, small business loans, feasibility studies, and public facilities grants. Thus far 44 communities in 22 States and Puerto Rico have been aided by this ongoing program.

One of the traditional areas of Government action in labor markets is assistance to the rapid and inexpensive exchange of information between those seeking work and those seeking workers. For many years, the Government has provided job information and direct placement services through the U.S. Employment Service, a cooperative Federal-State program. This information-placement effort has been and will continue to be improved by increasing the amount and reliability of data (especially increased information on job vacancies) by the use of modern data processing techniques (computerized listings of job openings, called "Job Banks") to cover ever-larger market areas, and by instituting flexible special placement programs focused on particular groups or areas most affected by special unemployment problems.

Direct governmental investments in training programs of various types are being reoriented to put special emphasis on training that will hasten the transition to career employment. These programs are intended to assist the unemployed and underemployed by developing their job skills so that they may qualify for primary jobs that provide adequate incomes and increased output. Manpower training programs enhance the flexibility and mobility of the workforce, and provide disadvantaged workers with opportunities to improve their well-being. Although already constructive, these manpower programs can be greatly improved by making them more flexible, innovative, and most importantly, responsive to local conditions and needs. This could be accomplished by passage and implementation of the President's proposed Manpower Revenue Sharing Act, which is now under consideration by the Congress. This Act would (1) consolidate most manpower-type programs under a single large-scale program, (2) eliminate most narrowly-targeted categorical grants, (3) shift detailed program decisionmaking from Washington, D.C., to State and local governmental units, and (4) increase training investments.

INFLATION AND UNEMPLOYMENT IN THE LONG RUN

We believe that the combination of the steady growth of demand, the temporary price-wage control system, and the manpower programs now in effect will make possible an unemployment rate much lower than the 6 percent we were experiencing in 1971 and an inflation rate without controls much lower than the 4 to 5 percent we were experiencing before the freeze. This will not, of course, be the end of either the inflation problem or the unemployment problem. The remaining problems can be summarized in two questions:

1. How can we avoid in the future the kind of inflationary surge of demand that occurred after 1965 and which determined the unique features of the economic problem with which the Nation has been wrestling for the past 3 years?
2. Even if such surges of demand are avoided, will the economy be left persistently with unsatisfactorily high unemployment, or unsatisfactorily high inflation, or both—even though both may be lower than at their 1970 or 1971 peaks? If so, what can be done about it?

THE CONTROL OF DEMAND

With respect to the first of these questions probably the greatest contribution would be to keep alive the memory of our recent experience. We have now come to see more vividly than ever before how long and painful is the effort to halt the inflationary process once it has been let loose. The avoidance of inflation is always, of course, an objective of national policy, and was an objective in 1965–66 when the present episode began. But this objective may not get its proper weight because of failure to foresee the losses of output and employment that will later be entailed in ending the inflation. Remembering the experience of 1969–71 should help to correct this error.

Adherence to the principle of keeping expenditures that would be made at full employment within the level of the receipts that would be yielded by the existing tax system under conditions of full employment would contribute to the avoidance of inflationary surges of demand. Certainly the shift of the budget position from approximate balance at full employment in fiscal 1965 to a large full-employment deficit in fiscal 1968 was a major cause of the current inflation. There are rare circumstances in which a deficit or surplus at full employment may be unavoidable or even appropriate economic policy. But in general more reliable results will be achieved from minimizing such departures than from following any of the alternative courses—trying to balance the actual budget continuously, disregarding budget balance, or making annual ad hoc decisions about the proper size of the deficit or surplus. Continuous balancing of the actual budget would require the perverse action of increasing expenditures or cutting tax rates when the private economy was booming and generating a large amount of tax revenue. Disregarding the budget balance rule would leave the enormous impact of the budget a random and destabilizing force on the economy. And a policy of ad hoc decisions about deficits or surplus is exposed to the political bias in favor of spending and deficits.

A similar precept of steadiness with respect to monetary policy would also help to avoid inflationary excesses of demand. The problem is that there is no single measure or objective combination of measures of monetary policy that is a completely satisfactory or completely superior measure of monetary policy by which a principle of steadiness could be calibrated. Judgment must be exercised. However, there is probably a presumption against extreme values or variations of the rate of change of narrowly-defined money, i.e., currency plus demand deposits.

The problems of managing fiscal policy or monetary policy or both have apparently been underestimated. It may well be that more has been promised than can be delivered with existing knowledge and instruments. Certainly there is need for much additional research. But if the question is not one of keeping the economy on a narrowly-defined path but one of avoiding violent aberrations like the one that began in 1965, our tools are probably adequate, and the problem is more the national will than the techniques of economics and economic policy.

Two years ago in this *Report* we recommended the establishment of a Commission to study the structure of financial institutions in the United States. One reason for this study, although not the primary one, was to see if ways could be found to make the financial structure a better vehicle for transmitting monetary policy into the economy. A distinguished group of citizens has now completed and published this study, which will be reviewed by this Administration and others to determine what action should be taken on its recommendations.

VIEWS OF THE INFLATION AND UNEMPLOYMENT PROBLEM

The persistence of a combination of high unemployment and rapid inflation for a longer period in 1970 and 1971 than seemed consistent with earlier experience appeared to support the view that inflation or unemployment or both had become structural features of the American economy. This is not the only possible explanation of the developments of 1970–71. The preceding inflation had been exceptionally long and strong. Estimates of the likely duration of the disinflationary process based on extrapolations from milder inflations might simply have been wrong, without implying that there was a permanent problem. Nevertheless, even if a great deal of weight is properly placed, as we think it should be, on the specific inflationary residue of the 1965–68 history, the hypothesis of a more durable problem still requires examination.

The problem might take one or more of three forms:

(a) A tendency to an unsatisfactorily high rate of inflation which persists over a long period of time and is impervious to variations in the rate of unemployment, so that the tendency cannot be eradicated by any feasible acceptance of unemployment.

(b) A tendency to an unsatisfactorily high rate of unemployment which persists over a long period and which is only temporarily influenced by increasing aggregate demand at an inflationary rate.

(c) A persistently unsatisfactory "trade-off" between inflation and unemployment such that it is permanently possible to have less inflation by accepting more unemployment, and vice versa, but with no combination possible that would be regarded as satisfactory.

Listing these possible problems does not imply that they exist. Nor would their existence imply any particular solution. Nevertheless the questions raised are obviously highly relevant to future economic policy. The Council of Economic Advisers will be making an intensive study of them during 1972, with the assistance of experts from other agencies of Government.

CHARACTERISTICS OF THE LABOR FORCE

One subject of major significance in identifying a satisfactory combination of employment and inflation conditions and a policy to achieve it is the character of the labor force and the labor market.

When what later became "The Employment Act of 1946" was first being discussed, under the title of "The Full Employment Act," there was a common notion that full employment meant zero unemployment. However, upon consideration it became clear that a situation of zero unemployment was not feasible, at least in a free society, nor, indeed, desirable in view of the costs that might be involved in achieving it. Some young people just entering the labor force, or women reentering it, or people dissatisfied with their previous place of residence or jobs, or having lost their previous jobs in the normal rise and fall of firms that goes on endlessly, would be in the process of looking for work. Unless there could be instantaneous adjustments—which there could not be—there would be a number of people between jobs even in what might be ideal conditions of the labor market.

This type of unemployment is frequently termed "transitional" and includes all or part of unemployment arising from the mobility of the American population, normal market frictions, seasonal variations, and some structural problems. In other words, it is that component of total unemployment which would respond to an expansion of demand only at high social cost, if at all.

Efforts were made when the 1946 Act was passed and shortly thereafter to estimate the normal size of the transitional group. This was difficult because the country had not been at anything like peacetime full employment since 1929 and relevant data were spotty. However, estimates converged on 4 percent as the proportion of the labor force that would be unemployed at "full" employment. This highly uncertain estimate became solidified over the ensuing years as a result of repetition, even though the 4 percent rate was seldom achieved.

This "minimum" unemployment rate, whatever it is, would not be expected to be stable over time. For one thing, persons of different age, sex, school attendance, and other characteristics would presumably have different rates of transitional unemployment.

Normal differences in transitional unemployment appear to explain much of the relatively high unemployment rates of young people and of women. In 1971 the unemployment rate for 16–19 year-olds was 16.9 percent, compared to a rate of 3.2 percent for married males; in 1969, a year of very tight labor markets, the rate for teenagers was 12.2 percent, compared to 1.5 percent for married males. The persistence of this large differential in both good times and bad suggests that factors other than the lack of aggregate demand cause the differential.

The primary activity of most teenagers is school. In October 1970, 70 percent of all 16–19 year-olds and about 55 percent of the teenage labor force were enrolled in school. For these youngsters, summer vacations, reentering school, going in and out of training programs or college or military service are all reasons for entering or leaving the labor force or for changing jobs. With many of these changes some unemployment is normal and it is not surprising that more than two-thirds of all teenage unemployment is associated with entering or reentering the work force.

The amount of labor force turnover of adult women appears lower than that of teenagers but greater than that of men. Because of child care and family responsibilities, women are likely to enter and leave the work force more frequently than men, both over the course of a year or a lifetime. By contrast adult males have a very stable attachment to the labor force. About 83 percent of males 20 years and over are in the labor force (96 percent of those 25–54 years) and only a trivial proportion are voluntary part-time or part-year workers.

Differences in turnover are reflected in differences in the reasons for unemployment of the different groups. In 1971, 82 percent of all unemployed 16–19 year-olds were unemployed as a result of voluntarily leaving their last job or of entering or reentering the labor force. The proportion of adult females in this category was 58 percent, but for adult males the proportion was only 34 percent. Job loss is the primary reason that adult males are unemployed.

During 1971, 16–19 year-olds accounted for 25 percent of all unemployment, compared to 17 percent in 1956. The relative increase in teenage unemployment reflects both an increase in the teenage population and an increase in their unemployment rate. Given that work in the market is less and less a primary activity for teenagers, their labor force turnover, and hence their transitional level of unemployment, may have increased.

Job opportunities for teenagers may be limited by a variety of factors. The pool of jobs available at any given time may require more experience or education than that typically found among younger workers. Available jobs may also require certain continuity of work (hours per week or weeks per year) which many teenagers are unable to meet because of the conflict with normal school hours. All these factors tend to direct teenage job seekers into occupations which are marginally productive and where demand may be particularly vulnerable to adverse employment effects of the minimum wage. The rising levels and expanded coverage of the minimum wage since the middle fifties may have been a factor in the upward drift of the teenage unemployment rate. For this reason the Administration has urged the provision of a lower minimum wage for teenagers to prevent any further narrowing of job opportunities.

TABLE 25.—*Hypothetical unemployment rates based on 1956 unemployment rates and distribution of civilian labor force, by age and sex: selected years, 1956–71, and projections, 1985*

[Percent]

Group	1956	1961	1966	1971	1985
Hypothetical unemployment rates:					
Using 1956 age-sex rates [1]	[2] 4.1	4.2	4.4	4.5	4.4
Percentage distribution of civilian labor force: [2]					
Civilian labor force	100.0	100.0	100.0	100.0	100.0
Females	32.2	33.8	36.0	38.2	37.7
16–19 years	2.8	3.0	3.8	3.9	2.9
20–24 years	3.7	3.8	4.7	6.0	5.7
25–54 years	20.6	21.2	21.3	21.9	23.0
55 years and over	5.2	5.7	6.2	6.3	6.1
Males	67.8	66.2	64.0	61.8	62.3
16–19 years	3.7	4.0	4.9	4.9	3.7
20–24 years	5.2	6.0	6.4	7.4	7.5
25–54 years	45.6	43.8	41.0	38.6	41.5
55 years and over	13.3	12.4	11.8	11.0	9.6

[1] Assumes 1956 unemployment rates by detailed age-sex groups (generally by 10-year age groups).
[2] Actual.

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

Source: Council of Economic Advisers; based on Department of Labor data.

To the extent that these transitional unemployment problems are unique to different ages and stages of life, the total amount of such unemployment will depend on the proportions of the labor force represented by persons in the various groups. Table 25 shows the change in the composition of the labor force by age and sex that occurred in the past 15 years and that projected for 1985. It also shows what the average unemployment rate would have been or will be if the unemployment rate in each age-sex category were at its 1956 level (1956 was selected as a base because it was a peacetime year of high employment and low inflation). This calculation does not reflect changes that may have occurred in the exposure of a particular age-sex category to transitional unemployment, such as may have been caused by lengthened school attendance, or any offsetting factors arising from increased education or more efficient labor market mechanisms. It is presented here as an example of one of the more obvious problems of attaining full employment in a dynamic and changing economy. The projection that women will continue to constitute a high proportion of the labor force suggests a continuing relatively high level of transitional unemployment.

The fact that the amount of "transitional" unemployment may be rising implies something about what can be achieved by general expansive measures alone, although the full implication will not be known until we can observe the behavior of unemployment in the current expansion. However, these developments also imply the need to do more directly about transitional unemployment. In fact, over the past 10 years Federal efforts to deal with this problem have increased substantially, and this Administration has supported intensification and improvement of these efforts.