Economic Review and Prospect

A Summary

Rarely has economic policy made so much news as in 1971. The freeze and Phase II, closing the gold window and prospective devaluation, domestic and international meetings at Camp David, the Azores, the Smithsonian Institution, and Bermuda, Key Biscayne, and San Clemente—all were continuing headline stories. These dramatic events were part of the process of dealing with problems in the forefront of public attention—inflation, unemployment, the international position of the U.S. economy.

These policies and their sequels and consequences will be the economic news of 1972. Most of this report is devoted to them. But this inevitable concentration on the news, whether in the press or in this report, can give a misleading impression of what is happening. The most important part of what is happening, at least in the field of economics, is not what was new last year or what will be new this year, but what is continuing.

THE LONGER VIEW

Before turning to the news it is worthwhile to point out some of the facts that are not news. The simplest and most far reaching is that total output per capita in 1971 was higher in the United States than anywhere else in the world. Output per worker, per hour of work and—as far as can be estimated—per unit of all resources were also the highest in the world. In all of these dimensions the economy continued to progress in 1971. In all of them the figures showed record highs last year. Labor productivity—output per hour of work—rose more rapidly than it had for several years.

In 1971, as in 1970 and 1969, there was a major shift in the allocation of total output from military to civilian uses. Measured in yearend 1971 dollars the annual rate of national defense spending declined by $25 billion from the fourth quarter of 1968 to the fourth quarter of 1971, or from 9.4 percent of GNP to 6.7 percent. In 1971, as in most other years, the largest part of the increase in total output was devoted to private consumption. Real private consumption increased 3.4 percent from 1970 to 1971, or 2.2 percent per capita. It amounted to $3,200 per capita in 1971 prices.

Most of the national income, and most of the increase of the national income, is the compensation of employees. In recent years an extraordinarily large share of the increase of the national income, 91 percent from 1968 to 1971, has gone into labor compensation. Real compensation per hour of work increased 2.5 percent from 1970 to 1971, compared to 1.2 percent average from 1968 to 1970. On the average during 1971 there were 79 million

people at work, the highest number on record. In November the count passed 80 million for the first time.

The efficient use of resources reflected in these figures is so commonplace in America that it is rarely news. However, in the context of world history, the American achievement is exceptional. It has not occurred automatically, but is the result of private and public efforts. In 1971, as in the past, measures to improve efficiency were important components of government policy.

In Chapter 4 of this *Report* we discuss issues relating to the continuing effectiveness of the economic system that are now of special concern. They are issues of national policy with respect to improvement of the environment, the supply of energy, research and development, surface freight transportation, and the provision of health care. Each of these issues has its unique features, but one aspect common to all of them should be emphasized at this time when we are engaged in comprehensive regulation of prices: They all reveal the difficulties that arise in the absence of an adaptive price system, whether that absence results from the natural condition of the private economy or from government regulation.

The basic environmental problem, for example, is that some resources, like air, are common property and consequently the private economic system does not put a price on their use. The result is overuse or misuse—such as the dumping of excess pollutants into the air. Similarly, much of the knowledge that can be created by research and development becomes a free good, so that private people do not have an adequate incentive to produce it. A part of the health problem is the difficulty of finding a pricing system for medical care which gives an incentive to economy in its use but at the same time assures adequate service for all. In the field of energy we see that a shortage and high prices of fuels may be caused by regulation intended to hold down the price of fuel. And in surface freight transportation too stringent regulation of rates keeps goods from being moved in the most efficient and cheapest way.

The lesson of all this is not *laissez-faire*. There are conditions where a functioning price system does not naturally exist and has to be created or simulated. But the lesson is of the great and cumulative losses likely to result from continued suppression of the price system where it is functioning in anything like the normal manner.

URGENT PROBLEMS OF 1971

However important such matters are for the long run, they were overshadowed in 1971 by the urgent questions of unemployment, inflation, and the balance of payments. At the beginning of 1971 each of these problems had already been around for a long time. The balance-of-payments problem was the oldest. There had been uninterrupted concern with the excess of U.S. payments abroad over receipts from abroad since 1959. Attempts had been made from time to time to limit the outflow of dollars by controls on capital flows and in other ways—but without lasting success.

The inflation problem had its origin in the middle of 1965, with the increase of spending for the Vietnam war, the steeply rising budgetary deficit at high employment, and the monetary expansion that accompanied it. Unemployment had been high although declining throughout the early 1960's until the Vietnam inflationary boom forced it down to low levels.

As 1971 opened there was common expectation that progress would be made on all these fronts. The rise of output which began in the spring of 1970 had been interrupted in October by the General Motors Corp. strike. But after the strike settlement the general expectation was that recovery would be resumed at a faster pace and unemployment would decline moderately in 1971. That was expected to be followed by a more certain and larger decline in 1972. Moreover, a widespread belief prevailed in and out of the Administration that 1971 would see a clear reduction in the rate of inflation.

Certainly the acceleration of the inflation rate had come to a halt. Persistent operation of the economy below potential in 1971, even though the economy was rising, seemed to offer reasons for expecting a reduction of the inflation rate. The inflation would still be proceeding too fast when the year ended; but the rate would have declined, and further decline would be in sight. Steady expansion in the U.S. economy, with rising productivity and a declining rate of inflation, would also help to strengthen our net export position and set us on the way to regaining balance-of-payments equilibrium.

The Administration's goals went beyond this common appraisal of the year 1971. It believed that a more rapid expansion of the economy than was generally forecast was desirable and feasible. The desirable and feasible path was believed to be one that would bring the unemployment rate down to the zone of 4½ percent by the middle of 1972.

The Administration believed that existing policy would move the economy along that path. That policy consisted of a budget that would keep expenditures from exceeding the revenues that would be collected at full employment, but that would show large deficits in fiscal years 1971 and 1972, and a complementary monetary policy. More important, the Administration emphasized its preparedness to adjust policy if evidence indicated the need to do so. The Administration's forecast that the economy would move along the feasible path was a forecast that policy would be adapted to achieve the desired result.

The Administration also indicated, in the *Economic Report* of 1971, its readiness to move directly to restrain price and wage increases that were not justified by competitive market conditions and were helping to prolong the inflation and unemployment. It did not, however, forecast conditions that would make comprehensive, mandatory price and wage controls appropriate.

EARLY PERFORMANCE IN 1971

In the first quarter of 1971 real output rose at an annual rate of 8 percent, the highest quarterly rise since early 1966. The unemployment rate de-

clined from 6.1 percent in December 1970 to 5.9 percent in February. The annual rate of increase of consumer prices in the first 4 months of 1971 was 2.9 percent, compared to 6.3 percent in the corresponding period of 1970. The surplus in foreign trade rose in the first quarter (seasonally adjusted).

Total output continued to rise throughout the year, and in the end it was close to the common expectations with which the year had opened. However, as the months of spring and early summer passed it became increasingly clear that the economy was not meeting the more ambitious goals of the Administration. First quarter GNP had been bolstered by the makeup from the General Motors strike to a greater degree than had been expected, and to a lesser degree by products other than automobiles. The rate of increase of real GNP fell to 3.4 percent in the second quarter—not enough to reduce the unemployment rate. The decline of the unemployment rate from December to February had not turned out to be the beginning of a steady improvement; by May the rate had returned to its December level. The decline in the rate of increase of the consumer price index had not continued, nor had the slowdown of inflation been confirmed by other measures. Although almost all measures showed that the rate of inflation was lower than it had been at its earlier peak, they gave little assurance that the rate was still declining.

The second quarter also brought a rapid deterioration in the U.S. balance-of-payments position. The trade balance, which had improved briefly in the first quarter, fell sharply in the spring. In addition the decline in U.S. interest rates relative to interest rates abroad in the early part of the year sharply increased the outflow of funds from the United States. These events gave rise to speculation which worsened the position further.

The combination of problems created a dilemma for economic policy. A rate of expansion and a level of unemployment less favorable than policy had projected could have been remedied by more expansive fiscal and monetary measures. But this remedy would have made the other problems worse. It would have stimulated the still lively expectations of continuing or even accelerating inflation and it would have speeded up the flight from the dollar. The problems had to be dealt with simultaneously.

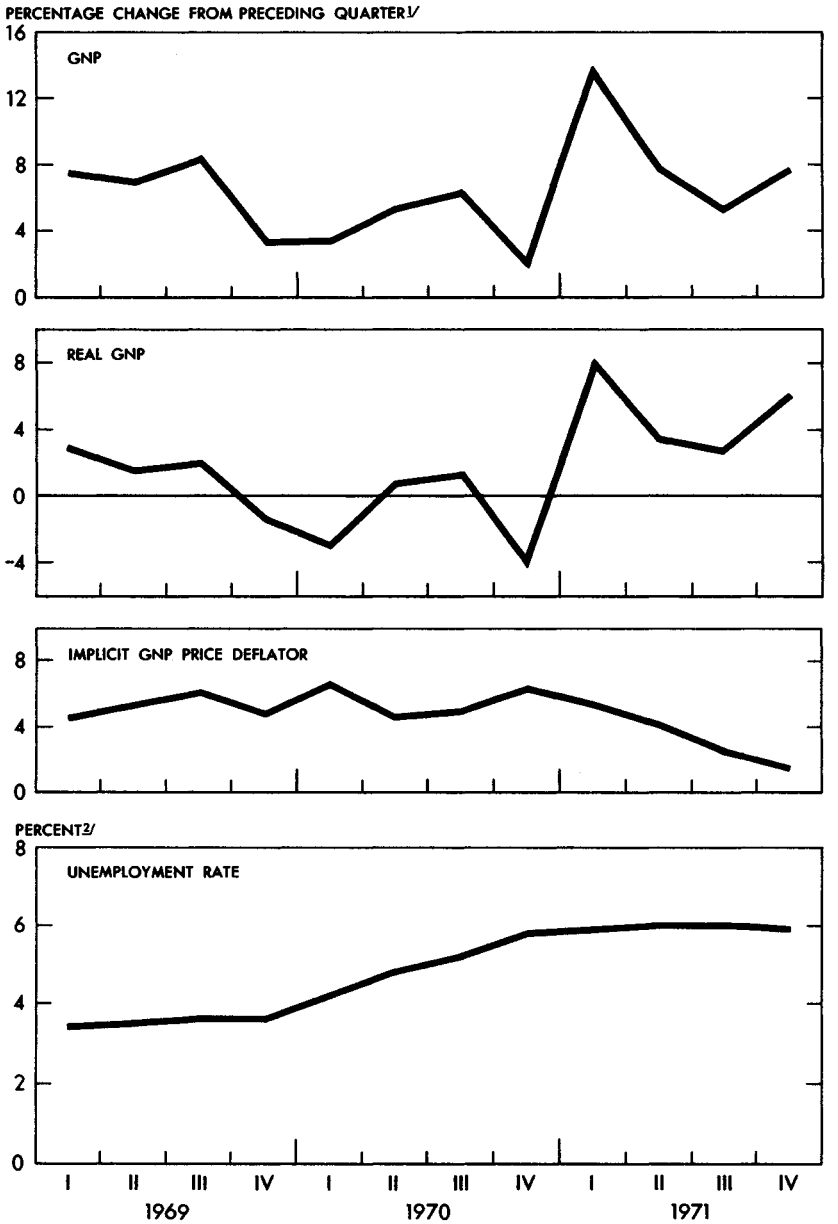
THE NEW ECONOMIC POLICY

This combination of facts and possibilities led to the decisive change of policy that was announced on August 15. The United States suspended the convertibility of the dollar into gold or other reserve assets, for the first time since 1934. It imposed a temporary surcharge, generally at the rate of 10 percent, on dutiable imports. Prices, wages, and rents were frozen for 90 days, to be followed by a more flexible and durable—but still temporary—system of mandatory controls. A package of tax reductions was proposed to stimulate economic expansion.

The suspension of dollar convertibility and the freeze were the dramatic elements in the announcement, and this might have led to an impression

Chart 1

Changes in GNP and Prices, and the Unemployment Rate



1/SEASONALLY ADJUSTED ANNUAL RATES.
2/UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE, SEASONALLY ADJUSTED.
SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR.

that the program was aimed primarily at solving the problems of the balance of payments and inflation rather than the problem of unemployment. In fact, the program was directed at all three problems. The international measures and the price-wage controls were both designed to create conditions in which a more expansive budget policy would be safer and more effective. The measures to deal with inflation and the balance-of-payments deficit were also expected to contribute to a reduction of unemployment. The import surcharge and the expected realignment of currencies would raise U.S. net exports, and as a byproduct contribute to employment in that way. Similarly, the price-wage control system was intended to stimulate spending and employment by reducing the inflation-anxiety of consumers and businessmen.

The two dramatic steps—the price-wage controls and the suspension of convertibility—had quite different roles in the future of the American economy. The price-wage controls were meant to be emergency expedients, required in a particular historical context but expected to fade away, leaving no permanent change in the system except the eradication of inflationary expectations. The suspension of convertibility, on the other hand, signalled the determination of the United States to achieve a permanent reform of the international monetary system.

By the end of 1971 substantial progress had been made in putting in place the policies announced on August 15. The Revenue Act of 1971, signed on December 10, incorporated the President's tax recommendations, with some revisions.

On December 18 the United States and 10 other major industrial countries agreed to a new set of international currency relationships and to intensive negotiations looking toward short-term measures of trade liberalization. At the same time they agreed to push on with longer-term discussions on new trade policies and on the international monetary system.

The price-wage freeze had given way to Phase II on November 14. The basic machinery had been established: The Pay Board, the Price Commission, and other bodies had been set up under general coordination by the Cost of Living Council. Overall principles had been set forth and specific regulations issued on a great many subjects. Individual cases were being decided. The system would be evolving as long as it lasted, but it was operational by the end of 1971.

FIRST RESULTS

Some of the first results of the New Economic Policy were already visible before 1971 ended. The most obvious were in the behavior of prices. The consumer price index rose 0.4 percent, seasonally adjusted, from August to November, compared to 1.0 percent in the previous 3 months. The index of industrial wholesale prices declined 0.3 percent, seasonally adjusted, compared to an increase of 1.6 percent in the previous 3 months. In December both indexes rose more rapidly, as was to be expected for a while imme-

diately after the freeze. Nevertheless, it was clear that the inflation rate had been slowed.

Expansive effects of the new policy were less clear and prompt, except in the case of automobile sales. The annual rate of sales of domestic autos rose to 10.1 million in the 3 months after August 15, compared with 8.2 million in the previous 3 months. This increase was due in part to the elimination of the 7-percent excise tax on automobiles; this change was not enacted into law until December, but it was known that it would be retroactively effective on August 15. The increase of sales was also influenced by the expectation of a price rise after the freeze. Total output of goods and services increased in the fourth quarter at the annual rate of 6.1 percent, compared to 2.7 percent in the third quarter. How much of this acceleration was due to the New Economic Policy was not measurable.

OUTLOOK FOR 1972

At the end of the year the prospect was that 1972 would see rising output, diminishing unemployment, a reduced rate of inflation, and a stronger U.S. position in the world economy.

A general indication of the prospective rise of the economy from 1971 to 1972 is that the gross national product (GNP) will probably increase by about $100 billion, compared with an increase of about $75 billion from 1970 to 1971. The increase in real output will be about 6 percent, compared to 2.7 percent in 1971, and the increase in prices from year to year will be around 3¼ percent, compared to 4.6 percent in 1971.

There are several reasons for expecting a significantly faster rate of increase of GNP from 1971 to 1972 than was experienced from 1970 to 1971. It seems likely that in 1972 every major category of expenditures for goods and services will rise more or decline less than in 1971, except for investment in new houses. After a period in which total sales have been rising and inventories have hardly changed, a sizable increase in business investment in inventories is probable. As a result of the adjustment in exchange rates, U.S. net exports should, during this year, stop falling and begin rising. After 3 years in which Federal purchases of goods and services have hardly risen in money terms, and have actually declined in real terms, purchases by the Federal Government will begin rising again. The general growth in output, plus the incentives of the recently enacted Job Development Credit and depreciation liberalization, will speed up business investment in plant and equipment. Consumer expenditures will increase more rapidly, spurred by rising earned incomes, tax reductions, larger social security benefits, and greater confidence in the future.

Federal budget policies will contribute to the increase in GNP in 1972 through tax reductions that stimulate both consumption and investment, as well as through increases in transfer payments to individuals, increased grants to State and local governments, and increases in its own purchases. The actual path of the economy in 1971 and the forecast for 1972 would result in

a budget deficit around $38.8 billion in fiscal 1972 (ending June 30, 1972) and $25.5 billion in 1973. The outlays that would be made at full employment would exceed revenues that would be collected at full employment by about $8.1 billion in fiscal 1972. In the next fiscal year, however, the budget would return to its target position of balance at full employment.

The role of monetary policy in the expansion ahead will be to provide for the increase of liquidity required to support increases in activity and income. This outcome will involve a resumption of the growth of the stock of currency and demand deposits, after 5 months in which there has been relatively little growth. The expectation of an increase of GNP around $100 billion is based on the assumption that the required monetary growth will be forthcoming.

The prospect is that we will have in 1972 not only a more rapid increase of GNP than in 1971 but also a slower rate of inflation. There are two reasons for expecting a slower rate of inflation. One is the accumulating effect of the continued operation of the economy below normal rates of employment and plant utilization, even though those operating rates will be rising in 1972. The other is the effect of the price-wage-rent control system.

The standards put forth by the Price Commission and the Pay Board, and the early experience with their application, give grounds for confidence that the system, operating within the general economic conditions in prospect for 1972, will contribute to a lower rate of inflation. These controls are operating in an environment in which other forces are contributing to a return to stability. If our fiscal and monetary policies are prudently managed there is little likelihood that the controls will be exposed to the pressure of excess demand.

With output rising at a rate of something like 6 percent a year, employment will rise strongly. This implies a fall in the unemployment rate to the neighborhood of 5 percent by yearend. The number of people experiencing some unemployment, and the average duration of their unemployment, would both be reduced.

These estimates, like all economic forecasts, are subject to a considerable margin of possible error. Circumstances are conceivable in which the rise of the economy would be less than these estimates suggest. The rise in the rate of inventory accumulation which is assumed to occur early in 1972 might be delayed. The demand for new housing may be less than is implied here, with a resulting decline of construction activity later in the year. The timing of the effects of the exchange rate realignment on trade flows is not certain. On the other hand, it is conceivable that the rise of the economy would be more rapid than projected here. The picture drawn here is not one of takeoff into a cyclical boom. At some stage the rise of final sales may trigger the above-average rise of inventories characteristic of strong recoveries. Increased utilization, rising profits, and reduced anxiety about inflation of cost, could stimulate larger business investment expenditure. The estimates

we have made presuppose continuation of personal saving at a higher rate than normal; a decline of that rate could significantly raise the economy.

Even given the course of the GNP in money terms, uncertainties would remain about the prospect for employment, unemployment, and prices. Variations in the rate of growth of the labor force and productivity, within the limits of historical experience, could significantly affect the outcome. And although the character and operation of the price-wage control system give grounds for confidence, it must be recognized that there is little relevant precedent for predicting its effects.

Uncertainties of this kind must be taken into account in policy decisions. The possibility that the rise of the economy and the decline of unemployment might lag behind the estimates made today calls for readiness to take additional steps if this should turn out to be the case. But the possibility that, with the policy now in place, the economy will rise even more rapidly than we foresee today is a strong reason for not seeking to stimulate the economy more now. One of the most common causes of the breakdown of price-wage control systems has been excess demand for goods and labor, which places upon the control system the burden of resisting market forces. The control system which has just been established is meant to assist market forces that would be working to hold down inflation; it is not meant to resist market forces working to accelerate inflation.

If excess demand is avoided, the control system can help to break the habitual or contractual repetition of large price and wage increases that keeps inflation going. It can generate the *expectation* of reasonable price stability that is essential to the *achievement* of reasonable price stability. And as that happens it will be possible to eliminate the controls. How soon that can be done will have to be determined in the light of experience.

The policy of restrained expansion of demand, coupled since August 15 with controls of prices and wages, will finally eradicate the continuing inflationary consequences of the boom that started in mid-1965. However, they will still leave questions that have troubled students of the American economy for many years. Are there persistent structural characteristics in the modern American economy that make inflation inevitable, or inevitable in the absence of high unemployment? If so, can these characteristics of the economy be changed? Upon the answers to these questions will depend the possibility of holding down the rate of inflation after Phase II ends, not only below the heights reached after the Vietnam war expansion, but to an even lower level. These questions will be the subject of study by the Council of Economic Advisers.

PROGRESS IN THE WORLD ECONOMY

The expected rise of the economy in 1972 results in limited part from an expected increase in U.S. exports relative to imports. This in turn results in part from the realignment of the dollar relative to other currencies. While this contribution to the recovery is a welcome consequence of the steps

that have been taken in the international economy, it is not their motivation or primary significance. By mid-1971 it was obvious that something had to be done to correct the U.S. balance-of-payments deficit, and that almost certainly required measures which would raise exports relative to imports. The question was how to bring that about. The August 15 decisions expressed the U.S. determination not to do it either by depressing the American economy or by imposing controls on foreign trade. The reasons for avoiding such controls need constant repetition. Americans have much to gain from being able to buy what they like where they like and being able to sell what they like where they like. The moves in the international monetary field were taken in an effort to solve the balance-of-payments problem by means that would preserve this freedom.

Moreover, the object of the steps taken was not just to solve the U.S. 1971 problem but to move toward better solutions for the future problems of the United States and the world. Since the United States suspended convertibility, agreed to propose to the Congress an increase in the dollar price of gold, and achieved a realignment of currencies, everyone is much more aware that the problem of one major currency is the problem of all and that the international financial system must be made more compatible with prosperity and freedom for all. The events of 1971 have created a favorable atmosphere for progress in reforming the system.

The events of 1971 also helped to revive the possibility of resuming movement toward reduction of international trade barriers. The international economic community was suddenly confronted with the prospect that if it could not agree to move forward together toward liberalization it could easily fall backward. Fortunately, the decision was to move forward together, and negotiations are underway which promise improvement in trading conditions for the United States and others.

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The agenda of economic policy for 1972 is a heavy one. The expansion of the economy must be guided along a steady path. The new price-wage control system must be developed and refined further. Negotiations now begun for trade liberalization must be pursued. Serious work must be carried forward on the international monetary system. And, as always, we must be prepared with new initiatives to meet needs that are not now foreseen. But while much remains to be done we can be confident that we are now on our way to goals that have eluded the American people for many years.