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 2½ 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 6¾-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	[3] 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.

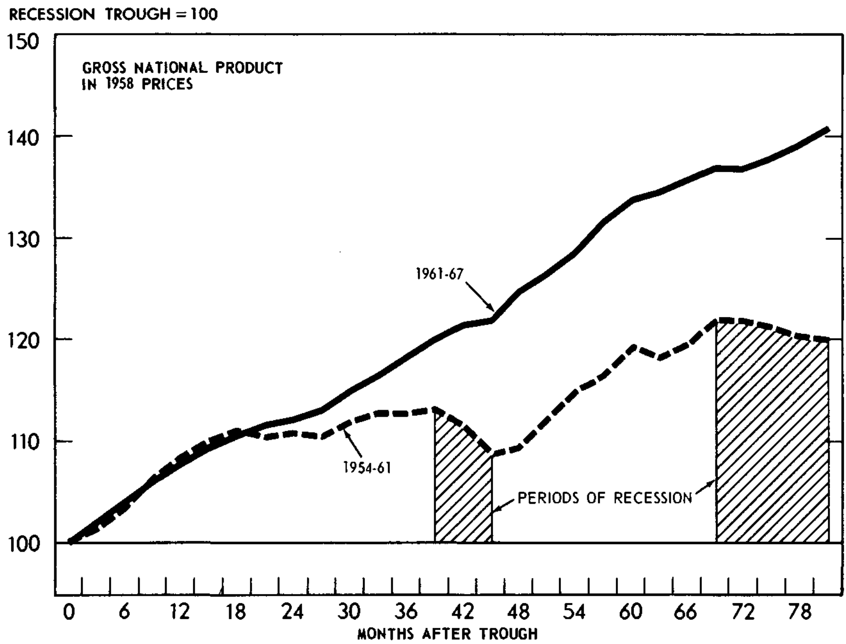
Sources: Department of Commerce, Department of Labor, and Council of Economic Advisers.

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.

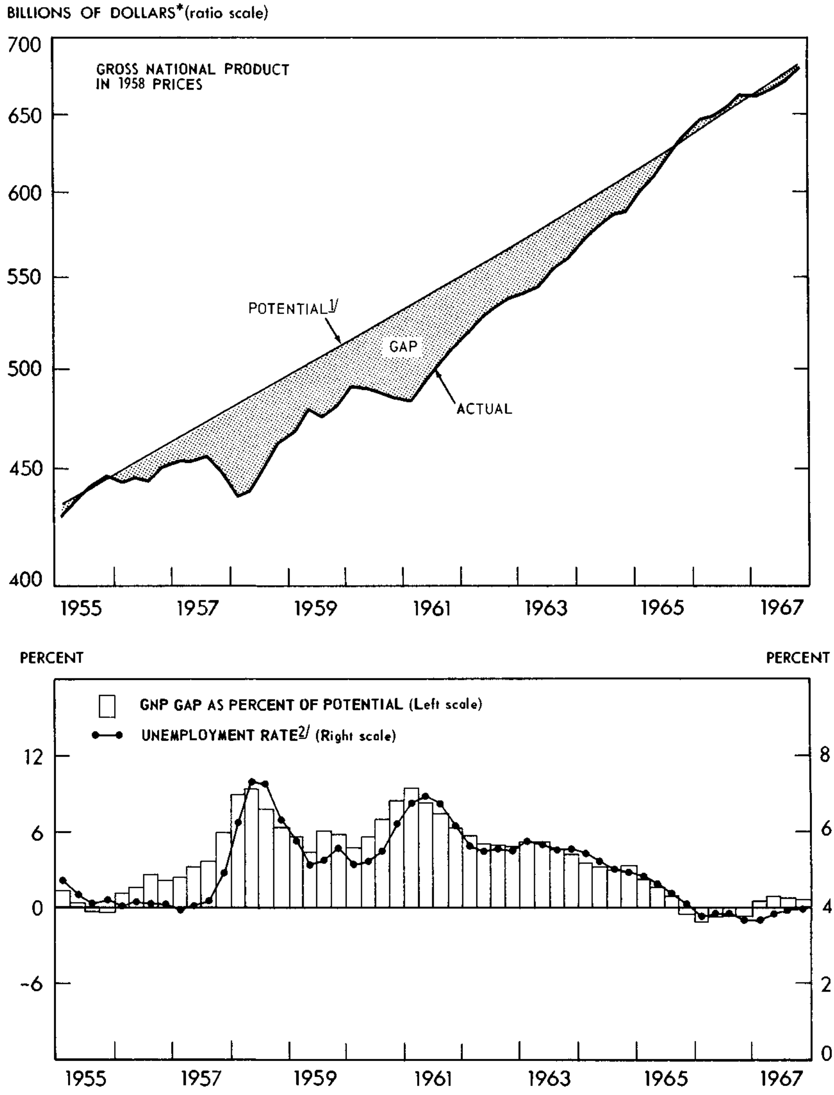
formance of the economy topped this by $120 billion—a difference larger than the current total of Federal purchases of goods and services.

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



*SEASONALLY ADJUSTED ANNUAL RATES.

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

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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 1½-percent rise in available man-hours and a 2½-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 1¾ 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 ¼ percent in average hours worked per year. This holds the trend of growth in total man-hours to about 1½ 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 2½ percent a year. The growth rate of potential output is therefore about 4 percent a year currently. It exceeds the 3½-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 $½ 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 recovery 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.

$30\frac{1}{2}$ billion. Because expansionary actions exceeded this "fiscal dividend," the full-employment surplus was reduced by $7\frac{1}{2}$ 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.

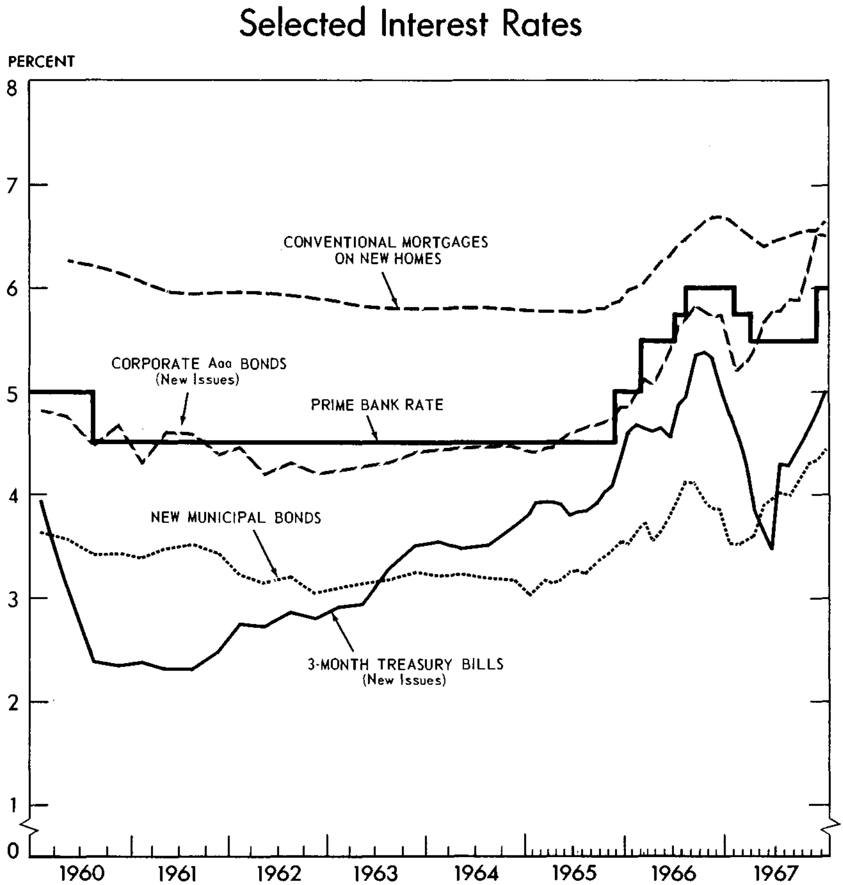
A policy of monetary ease was indispensable to provide the 60-percent increase in funds raised by businesses, governments, and individuals without any substantial tightening of availability or increase in long-term rates. Meanwhile, demands for funds burgeoned mainly because of the invigoration of demands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



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.

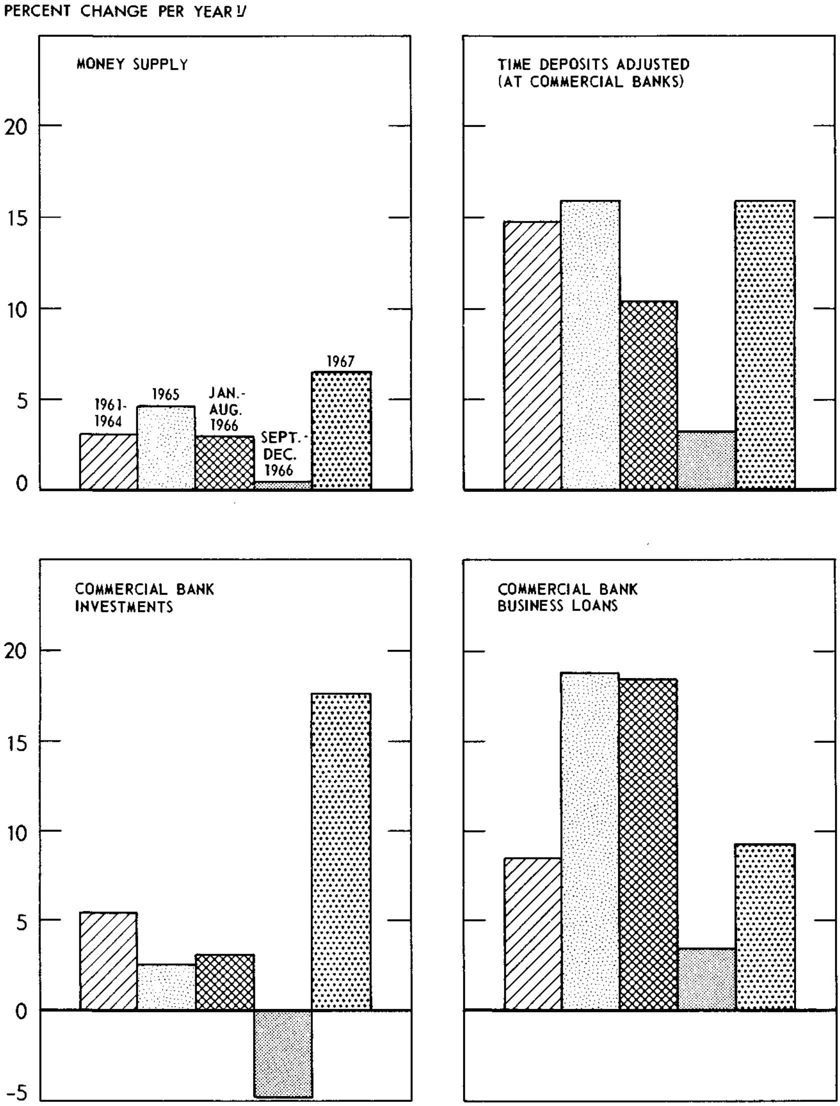
Further, monetary policy had turned expansionary, in order to help cushion the inventory adjustment, and to assist actively in the recovery of homebuilding. The Administration's proposal for a special income tax surcharge in the second half of the year was intended to reduce Government demands on the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

Chart 6

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



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.

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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 4½ 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 3⅓ percent, compared to the peak of 5½ percent in the previous September. Declines in other short-term rates were in the range of 1½ to 2 percentage points.

Long-term rates, however, reached their low in late February, when they stood ½ to ¾ 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.

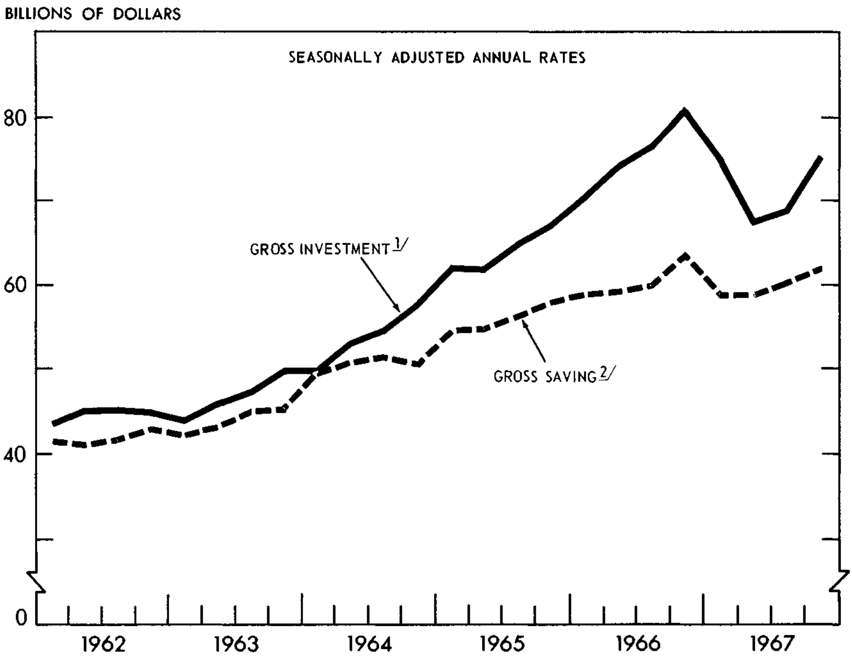
The volume of corporate security issues registered a substantial increase in volume of $3.7 billion in 1967, even though the gap between the flow of corporate internal funds and corporate expenditures for investment was smaller than in 1966 (Chart 7). In part, the explanation for the exceedingly large 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



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 purchasing 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 statement 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

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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.