THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS
LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,


THE PRESIDENT:


Respectfully,

HERBERT STEIN,
Chairman.

Ezra Solomon.
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Economic Review and Prospect

A Summary

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

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

THE LONGER VIEW

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

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

Most of the national income, and most of the increase of the national income, is the compensation of employees. In recent years an extraordinarily large share of the increase of the national income, 91 percent from 1968 to 1971, has gone into labor compensation. Real compensation per hour of work increased 2.5 percent from 1970 to 1971, compared to 1.2 percent average from 1968 to 1970. On the average during 1971 there were 79 million
people at work, the highest number on record. In November the count passed 80 million for the first time.

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

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

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

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

URGENT PROBLEMS OF 1971

However important such matters are for the long run, they were overshadowed in 1971 by the urgent questions of unemployment, inflation, and the balance of payments. At the beginning of 1971 each of these problems had already been around for a long time. The balance-of-payments problem was the oldest. There had been uninterrupted concern with the excess of U.S. payments abroad over receipts from abroad since 1959. Attempts had been made from time to time to limit the outflow of dollars by controls on capital flows and in other ways—but without lasting success.
The inflation problem had its origin in the middle of 1965, with the increase of spending for the Vietnam war, the steeply rising budgetary deficit at high employment, and the monetary expansion that accompanied it. Unemployment had been high although declining throughout the early 1960's until the Vietnam inflationary boom forced it down to low levels.

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

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

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

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

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

EARLY PERFORMANCE IN 1971

In the first quarter of 1971 real output rose at an annual rate of 8 percent, the highest quarterly rise since early 1966. The unemployment rate de-
clined from 6.1 percent in December 1970 to 5.9 percent in February. The annual rate of increase of consumer prices in the first 4 months of 1971 was 2.9 percent, compared to 6.3 percent in the corresponding period of 1970. The surplus in foreign trade rose in the first quarter (seasonally adjusted).

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

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

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

THE NEW ECONOMIC POLICY

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

The suspension of dollar convertibility and the freeze were the dramatic elements in the announcement, and this might have led to an impression
Chart 1

Changes in GNP and Prices, and the Unemployment Rate

PERCENTAGE CHANGE FROM PRECEDING QUARTER

GNP

REAL GNP

IMPLICIT GNP PRICE DEFLATOR

UNEMPLOYMENT RATE

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

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

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

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

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

FIRST RESULTS

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

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

OUTLOOK FOR 1972

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

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

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

Federal budget policies will contribute to the increase in GNP in 1972 through tax reductions that stimulate both consumption and investment, as well as through increases in transfer payments to individuals, increased grants to State and local governments, and increases in its own purchases. The actual path of the economy in 1971 and the forecast for 1972 would result in
a budget deficit around $38.8 billion in fiscal 1972 (ending June 30, 1972) and $25.5 billion in 1973. The outlays that would be made at full employment would exceed revenues that would be collected at full employment by about $8.1 billion in fiscal 1972. In the next fiscal year, however, the budget would return to its target position of balance at full employment.

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

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

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

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

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

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

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

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

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

PROGRESS IN THE WORLD ECONOMY

The expected rise of the economy in 1972 results in limited part from an expected increase in U.S. exports relative to imports. This in turn results in part from the realignment of the dollar relative to other currencies. While this contribution to the recovery is a welcome consequence of the steps
that have been taken in the international economy, it is not their motivation
or primary significance. By mid-1971 it was obvious that something had to be
done to correct the U.S. balance-of-payments deficit, and that almost cer-
tainly required measures which would raise exports relative to imports. The
question was how to bring that about. The August 15 decisions expressed the
U.S. determination not to do it either by depressing the American economy
or by imposing controls on foreign trade. The reasons for avoiding such
controls need constant repetition. Americans have much to gain from being
able to buy what they like where they like and being able to sell what they like
where they like. The moves in the international monetary field were taken in
an effort to solve the balance-of-payments problem by means that would
preserve this freedom.

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

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

* * *

The agenda of economic policy for 1972 is a heavy one. The expansion
of the economy must be guided along a steady path. The new price-wage
control system must be developed and refined further. Negotiations now
begun for trade liberalization must be pursued. Serious work must
be carried forward on the international monetary system. And, as
always, we must be prepared with new initiatives to meet needs that are
not now foreseen. But while much remains to be done we can be confident
that we are now on our way to goals that have eluded the American people
for many years.
CHAPTER 1

Performance and Policy to Mid-August

ON AUGUST 15, 1971, the President announced a far-reaching New Economic Policy designed to check the rise in prices and wages, strengthen the Nation’s external economic position and stimulate economic activity at home. To curb the rate of inflation, prices, wages, and rents were subjected to a 90-day freeze, which was followed by a comprehensive but more flexible system of mandatory controls. To improve the Nation’s balance of payments, the President suspended the convertibility of the dollar into gold and other reserve assets and imposed a temporary 10-percent surcharge on imports. And to strengthen the domestic economy, the President proposed, in addition to these measures, a fiscal package whose stimulus came from a set of tax cuts, which were passed by the Congress in December in somewhat altered form.

Results of the new program were visible in varying degrees by the end of the year. They were most apparent in the slowdown of price and wage increases during the freeze. On the international front the major industrial countries agreed to a realignment of currencies more favorable to the U.S. competitive position and to prompt discussions concerning trade barriers and long-term monetary reform. The strong upsurge in purchases of automobiles from mid-August through November was partly a result of the proposed removal of the Federal excise tax, but much of it was apparently an attempt by consumers to buy automobiles before prices were increased in the post-freeze period. Perhaps the most significant effect of the combined package was the impact on public confidence. From mid-August to the end of the year, there was slow but steady improvement in confidence that the rate of inflation was subsiding and the pace of the economic recovery was gathering strength.

The decision to embark on the New Economic Policy (NEP) came from an increasing awareness in the Administration that the ambitious goals it had set at the beginning of the year were not being met. Progress in the fight against inflation was proceeding too slowly, and its future success was uncertain. At the same time, the recovery was also progressing, but not fast enough to cut the rate of unemployment. More crucial than either of these for the timing of the decisions was the serious weakening of the dollar in international markets. As the summer wore on, there were no signs of a resolution of the financial crisis that in May caused the Swiss franc and the
Austrian schilling to be revalued and the German mark and the Netherlands guilder to be set free to float in value. In the second quarter, the U.S. balance of payments on the official reserve transactions basis had recorded a deficit of $23 billion at a seasonally adjusted annual rate, and in July and August pressure against the dollar reached enormous proportions. Funds totaling about $3.7 billion moved into foreign official reserve accounts in the week ended August 15. The time had come to deal decisively with the international financial problem that had persisted for at least a dozen years despite the efforts of four successive Administrations.

The domestic aspects of the New Economic Policy are discussed at the end of this chapter and in Chapter 2 and the international aspects in Chapter 5. The rest of this chapter deals with events and policies in 1971, generally up to the midsummer shift in policy.

DEMAND, OUTPUT, AND THE LABOR MARKET

The year 1971 was one of limited recovery in demand and production. During 1969 the Administration had actively sought to slow down the economy in order to control inflation. Those efforts had their major impact at the end of 1969 and early 1970, when the rise in demand slowed considerably and output dipped, after which policy shifted in the direction of expansion. A fragile recovery was reversed toward the end of 1970 by the lengthy and severe strike at General Motors. The underlying course of the economy was upward throughout 1971 and its pace was moderate for most of the year, but the actual course of events was irregular because of strikes and their aftermaths (Chart 1, p. 23).

Changes in demand and output as measured by GNP through the third quarter of 1971 are reviewed in the following pages. Although the NEP was announced in mid-August, it would be difficult to measure changes through the middle of the third quarter. In any case, the measured demand conditions of the third quarter are probably generally representative of the demand conditions at the time the August 15 decisions were made, although the increase of GNP in the quarter has turned out to have been lower than was expected at that time.

DEMAND PATTERNS

From the third quarter of 1970 to the third quarter of 1971, total GNP rose 7.1 percent or by $70 billion (Table 1). This was considerably more than the $43 billion rise over the preceding 4 quarters. The rise was dominated by increases in residential construction and State and local government purchases, both of which were especially responsive to the improvement in credit conditions. Consumption expenditures showed an above-average gain, while Federal purchases and business fixed investment were weak. The overall increase was held down by a reduction in business investment in inventories and by unexpectedly severe weakness in net exports. Indeed, if our economic performance were measured by domestic
Table 1.—Changes in gross national product in current and constant dollars, 1968 III to 1971 III

<table>
<thead>
<tr>
<th>Component</th>
<th>Change in seasonally adjusted annual rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current dollars:</td>
<td></td>
</tr>
<tr>
<td>Total GNP</td>
<td>65.0</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>40.1</td>
</tr>
<tr>
<td>Business fixed investment</td>
<td>11.9</td>
</tr>
<tr>
<td>Residential structures</td>
<td>1.0</td>
</tr>
<tr>
<td>Change in business inventories</td>
<td>2.7</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>-6.6</td>
</tr>
<tr>
<td>Federal Government purchases</td>
<td>-5.0</td>
</tr>
<tr>
<td>State and local government purchases</td>
<td>9.4</td>
</tr>
<tr>
<td>Gross auto product</td>
<td>1.7</td>
</tr>
<tr>
<td>All other product</td>
<td>63.3</td>
</tr>
<tr>
<td>Constant (1958) dollars:</td>
<td></td>
</tr>
<tr>
<td>Total GNP</td>
<td>15.5</td>
</tr>
<tr>
<td>Personal consumption expenditures</td>
<td>12.2</td>
</tr>
<tr>
<td>Business fixed investment</td>
<td>5.8</td>
</tr>
<tr>
<td>Residential structures</td>
<td>-5.5</td>
</tr>
<tr>
<td>Change in business inventories</td>
<td>-1.0</td>
</tr>
<tr>
<td>Net exports of goods and services</td>
<td>-5.2</td>
</tr>
<tr>
<td>Federal Government purchases</td>
<td>-1.9</td>
</tr>
<tr>
<td>State and local government purchases</td>
<td>-1.9</td>
</tr>
<tr>
<td>Gross auto product</td>
<td>14.6</td>
</tr>
<tr>
<td>All other product</td>
<td></td>
</tr>
</tbody>
</table>

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

Source: Department of Commerce.

The 7.1-percent increase in GNP reflected a 4.6-percent rise in prices and a 2.4-percent increase in physical volume. Although this increase in volume was an improvement over the decrease of 1970 and the 2.2-percent gain of 1969, it fell short of the rate required to keep unemployment from rising. Unemployment reached a peak around the beginning of 1971 and thereafter remained essentially on a plateau.

Consumer Income and Spending

Fiscal policy helped to buttress consumer income last year, as it had in 1970. Because the demand for labor was weak, the expansion in payrolls was
TABLE 2.—Changes in personal income, taxes, and disposable income, 1967 III to 1971 III

<table>
<thead>
<tr>
<th>Item</th>
<th>Change in seasonally adjusted annual rates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Item</td>
<td>1967 III to 1968 III</td>
</tr>
<tr>
<td>Wage and salary disbursements</td>
<td>44.7</td>
</tr>
<tr>
<td>Other earned income</td>
<td>12.4</td>
</tr>
<tr>
<td>Transfer payments</td>
<td>8.4</td>
</tr>
<tr>
<td>Less: Personal contributions for social insurance</td>
<td>2.4</td>
</tr>
<tr>
<td>Equals: Personal income</td>
<td>63.1</td>
</tr>
<tr>
<td>Less: Personal tax and nontax payments</td>
<td>18.7</td>
</tr>
<tr>
<td>Equals: Disposable personal income</td>
<td>44.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>45.8</td>
<td>13.4</td>
<td>28.7</td>
</tr>
<tr>
<td>5.8</td>
<td>8.6</td>
<td>14.9</td>
</tr>
<tr>
<td>3.5</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>61.5</td>
<td>50.5</td>
<td>54.8</td>
</tr>
<tr>
<td>13.4</td>
<td>-2.6</td>
<td>2.5</td>
</tr>
<tr>
<td>48.0</td>
<td>53.0</td>
<td>52.3</td>
</tr>
</tbody>
</table>

Note.—Detail will not necessarily add to totals because of rounding.
Source: Department of Commerce.

limited. Indeed, personal income excluding transfer payments rose only 5.4 percent from the third quarter of 1970 to the third quarter of 1971 (Table 2). However, transfer payments rose almost 20 percent, mainly because in the second quarter of 1971 Social Security benefits were increased, the change being retroactive to the beginning of 1971. Altogether the rise in total personal income during this period came to 6.8 percent. Because of the tax reductions under the Tax Reform Act of 1969 that became effective at the start of 1971, personal taxes declined relative to income. The 7.5-percent increase in disposable (after-tax) income was somewhat more than the average annual gain for the past decade in current dollars but not in real terms.

Personal consumption expenditures rose 7.7 percent from the third quarter of 1970 to the third quarter of 1971, or 3.4 percent in real terms. Spending on durable goods, which had changed little over the preceding year, rose much more than average even when allowance is made for the sharp increase in automobile purchases after August 15. What was noteworthy about consumer behavior during this period was the persistence of a very high rate of personal saving. The 8.3-percent rate from the third quarter of 1970 through the second quarter of 1971 was higher than any 4-quarter average since 1946. The rate peaked in the second quarter, coincident with the large payment of Social Security benefits, and edged down thereafter.

Business Investment

Despite the improvement in profits and cash flow and the greater availability of credit in 1971, business fixed investment in real terms changed little during 1971; the 4-percent rise in outlays from the third quarter of 1970 to the third quarter of 1971 was slightly less than the rise in prices. Excess plant capacity was the main factor discouraging investment.

Investment was not uniformly weak last year. The sluggishness centered in manufacturing and railroads, both of which showed typical cyclical re-
responses, and in airlines. With their output decreasing from 1970 to 1971 to a level far below capacity, manufacturers cut back their investment by 5½ percent from 1970 to 1971 after holding it even from 1969 to 1970. Increases were large for electric utilities, whose investment rose 20 percent over the year.

Although real investment declined during 1970, gauged by recessions in the postwar years the decrease was very mild—if allowance is made for the GM strike. As a share of real GNP, business fixed investment has remained high. The 10.6-percent share for 1971, although below the high average of 10.9 percent from 1965 through 1970, was above the average of 10.1 percent for the 20 years from 1951 through 1970.

At the start of 1971 the Administration announced that depreciation rules would be liberalized to stimulate fixed investment. The main features of this liberalization were a shortening of permissible useful lives of equipment and a change in the regulations affecting the calculation of depreciation in the year of acquisition. The Treasury Department estimated that in the first full year following these changes depreciation would be raised by $6½ billion and taxes on business income reduced by $2.8 billion. The liberalization, with first-year benefits considerably reduced, later became part of the Revenue Act of 1971. The new regulations were not expected to exert a large influence in 1971—the main benefits were expected to be achieved subsequently—but they may have played a role in the step up of appropriations and new orders for capital goods after the middle of the year.

The mildness of the recovery and uncertainty about the outlook caused businessmen to pursue cautious inventory policies during most of 1971. The $2 billion added to stocks during the year was even less than the small addition in 1970. Last year, special factors associated with strikes had the effect of stimulating inventory investment at first and depressing it subsequently. Automobile stocks were built up in the first half following the pronounced liquidation of stocks caused by the General Motors strike in late 1970. Prospects of a possible steel strike after July 31, the expiration date of the labor contract, caused steel consumers to build up stocks in the first 7 months of 1971, after which these inventories were liquidated.

The pattern of GNP change is altered if the change in investment in auto and steel stocks is excluded from the total, as is done below. On this basis the rise in GNP strengthened rather than weakened from the first to the third quarter as compared to the rise over the preceding 2 quarters.

<table>
<thead>
<tr>
<th>[Billions of dollars; seasonally adjusted annual rates]</th>
</tr>
</thead>
<tbody>
<tr>
<td>Change in GNP</td>
</tr>
<tr>
<td>Less: Change in investment in auto and steel stocks</td>
</tr>
<tr>
<td>Equals: Adjusted change in GNP</td>
</tr>
</tbody>
</table>

33
Residential Construction

Housing was the strongest sector of the economy in 1971. Private housing starts totaled more than 2 million units, the largest number recorded for any year. Residential construction outlays rose almost 50 percent, or $14 billion, from the third quarter of 1970 to the third quarter of 1971. This was one-fifth of the rise in total GNP.

The rise in housing was an extension of the recovery in starts that began in the spring of 1970 and reflected exceptionally strong demand in a setting of easing credit. Government subsidy programs and Government assistance in mortgage markets also contributed to the housing expansion. Demand for new homes had been partially frustrated during the second half of the 1960's, largely because of competing demands for credit by business and government in an environment of restrictive monetary policy in 1966 and in 1969. Traditional mortgage lending institutions, which were inhibited in their ability to attract savings deposits, reduced mortgage credit sharply. Mortgage interest rates rose to unusually high levels in 1969 and early 1970. From a peak in the first quarter of 1969 to a trough in the first quarter of 1970 private starts declined 24 percent. The decreases in private starts of 2.7 percent in 1969 and 2.3 percent in 1970 occurred at a time when increases in family formation and replacement demand suggested the production of more rather than fewer homes. Consequently, a backlog of housing demand, evidenced by extremely low vacancy rates, was carried into 1971.

The shift to an easier monetary policy in 1970 was the decisive factor in the turnaround in housing. This change, along with growing support from a number of Government-related housing institutions and a flood of savings deposits into mortgage lending institutions, greatly increased the availability of mortgage credit and brought the secondary market yield on FHA mortgages down slowly from the 9.29-percent peak that had been reached in March 1970.

The strength of demand showed up in several different ways. Sales of new one-family homes from January through October were 40 percent greater than the corresponding 1970 total. The ratio between the inventory of unsold homes and homes sold was lower than in any earlier year, at least since 1963, when numbers of this sort were first collected. Vacancy rates were low for both rental and homeowner units. Homeowner vacancy rates through the third quarter remained at their lowest levels in over a decade; and although the rental vacancy rate rose from 4.9 percent in the second quarter to 5.3 percent in the third, it remained low by the standards of the 1960's.

Other Demand

Purchases by State and local governments rose about as much during 1971 as during the preceding year. Improving credit conditions facilitated financing by State and local governments. There was no evidence of any
slowdown in the growth of payrolls, which make up close to three-fifths of State and local purchases; however, the rise in employment continued to slow down, while wage increases accelerated.

The deterioration in the Nation's trade balance is discussed in Chapter 5. Here it need only be noted that the deterioration had a significant effect on the change in GNP. In the third quarter of 1970, for example, net exports were at the comparatively high rate of $4.0 billion. In the third quarter of 1971, the balance had fallen to zero, with imports rising much more rapidly than exports. As a result, U.S. output of goods and services rose less than the domestic U.S. demand, because more of that demand was met from imports.

LABOR MARKET

Although growth of the labor force slowed down and civilian employment expanded somewhat before the start of the NEP, the unemployment rate remained near 6 percent through August and indeed through all of 1971 (Chart 1, p. 23). The stickiness of the jobless rate reflected primarily the slowness of the cyclical recovery of private demand, the continuing downward adjustments occurring in the defense sector, and the strong cost-cutting efforts in all sectors of the economy that resulted in greater output per hour of work.

Labor Force

The total labor force increased by about 1.1 million from the third quarter of 1970 to the third quarter of 1971, or by nearly one-third less than would normally be expected from population growth and long-run trends in labor force participation. Because of reductions in the Armed Forces, the civilian labor force expanded more than the total labor force, rising by about 1.5 million. For men aged 20 to 24, increases in the civilian labor force were particularly large again in 1971, reflecting the return of ex-servicemen to civilian activity (Table 3 and Chart 2).

**Table 3.—Changes in the working-age population, Armed Forces, and labor force, 1962 to 1971 III**

<table>
<thead>
<tr>
<th>Group</th>
<th>Change (millions of persons, 16 years and over)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Noninstitutional population</td>
<td>2.1</td>
</tr>
<tr>
<td>Total labor force</td>
<td>1.2</td>
</tr>
<tr>
<td>Armed Forces</td>
<td>(1)</td>
</tr>
<tr>
<td>Civilian labor force</td>
<td>1.3</td>
</tr>
<tr>
<td>Men 20 to 24 years</td>
<td>.2</td>
</tr>
<tr>
<td>Men 25 years and over</td>
<td>.1</td>
</tr>
<tr>
<td>Women 20 years and over</td>
<td>.6</td>
</tr>
<tr>
<td>Both sexes 16 to 19 years</td>
<td>.3</td>
</tr>
</tbody>
</table>

1 Decrease of less than 50,000.

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

Source: Department of Labor.

35
Chart 2

Labor Force, Employment, and Armed Forces

SEASONALLY ADJUSTED

TOTAL LABOR FORCE

CIVILIAN EMPLOYMENT

CIVILIAN LABOR FORCE

SOURCE: DEPARTMENT OF LABOR.
Long-run increases in the size of the Nation’s labor force are governed primarily by the growth of the working-age population (persons 16 years of age and older). Over shorter periods, labor force changes are affected by cyclical changes in economic activity. On balance, when labor demand is strong, additional workers enter the labor force, attracted by plentiful job opportunities, and when labor demand is not strong there is often a net decline in participation. This responsiveness to changing demand conditions cannot be measured with great precision; but during the period of very tight labor markets in the late 1960’s, when unemployment was low, overall labor force participation rose sharply. From early 1970 to about mid-1971, participation rates declined.

Employment

Reflecting the relatively mild expansion of aggregate demand and employers’ efforts to raise productivity, total civilian employment rose only 700,000 over the year ending in the third quarter. A large share of the employment increase occurred in State and local governments. In the private nonfarm sector, continued growth of employment in service-producing industries was largely offset by further small declines in the goods-producing industries.

This pattern of employment changes was similar to patterns after earlier recessions with one major exception: There was no rebound in manufacturing employment. Within manufacturing, reductions by producers of defense goods and their suppliers continued to be large; from December to August, employment in three industries primarily engaged in the production of military hardware—ordnance, aircraft and parts, and communications equipment—declined at an annual rate of 212,000 jobs. By August, after the sharp layoffs in the steel industry, manufacturing employment had fallen below 18.5 million, its lowest point since December 1965. Total man-hours worked in factories in the third quarter of 1971 were down nearly 10 percent from the peak reached in late 1969.

Defense Adjustment

The progressive winding down of the U.S. military involvement in Vietnam and a general realignment of defense spending have sharply reduced manpower utilization in defense activities. Although the largest cuts caused by this realignment are now behind us, imbalances and distortions arising from the transition are still an important factor in the labor market.

In all, there has been a net reduction of about 2.0 million persons in defense during the past 3 years (Table 4). The steady flow of young veterans out of the Armed Forces, which was more than twice as large as the net reduction in the Armed Forces in 1970 and 1971, created a special unemployment problem, because most young men leaving the service require somewhat longer than the average period to find work in local job markets. Unemployment among former defense industry workers also tends to last longer than the average because of their relatively specialized skills and
TABLE 4.—Employment attributable to defense expenditures and personnel requirements, 1965 and 1968-71

[Millions of persons]

<table>
<thead>
<tr>
<th>Type of employment</th>
<th>1965</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defense-generated employment</td>
<td>6.2</td>
<td>8.0</td>
<td>7.5</td>
<td>6.7</td>
<td>6.0</td>
</tr>
<tr>
<td>Public employment</td>
<td>3.7</td>
<td>4.6</td>
<td>4.6</td>
<td>4.2</td>
<td>3.8</td>
</tr>
<tr>
<td>Federal military</td>
<td>2.7</td>
<td>3.5</td>
<td>3.5</td>
<td>3.2</td>
<td>2.8</td>
</tr>
<tr>
<td>Federal civilian</td>
<td>1.0</td>
<td>1.1</td>
<td>1.1</td>
<td>1.0</td>
<td>1.0</td>
</tr>
<tr>
<td>Private employment</td>
<td>2.5</td>
<td>3.4</td>
<td>2.9</td>
<td>2.5</td>
<td>2.2</td>
</tr>
</tbody>
</table>

1 Estimates primarily based on national income and product accounts, which include atomic energy programs.
2 Preliminary estimates.

Note.—Data are calendar year averages.
Detail will not necessarily add to totals because of rounding.

Source: Department of Labor.

Their residence in communities where large defense contractors are the major employers. Persons and communities affected by defense cuts have been beneficiaries of a variety of Government programs which are tailored to their particular problems (see Chapter 3, pp. 109-10).

Unemployment

After rising steeply to approximately 6 percent of the work force at the end of 1970, unemployment leveled off in 1971. Jobless rates for most groups were unusually steady from late 1970 to late 1971 (Table 5).

TABLE 5.—Selected unemployment rates, 1969 IV–1971 IV

<table>
<thead>
<tr>
<th>Selected groups of workers</th>
<th>1969 IV</th>
<th>1970 IV</th>
<th>1971</th>
<th>1971</th>
</tr>
</thead>
<tbody>
<tr>
<td>All workers</td>
<td>3.6</td>
<td>5.8</td>
<td>5.9</td>
<td>6.0</td>
</tr>
<tr>
<td>Sex and age:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Men 20–24 years</td>
<td>5.7</td>
<td>10.7</td>
<td>10.0</td>
<td>10.3</td>
</tr>
<tr>
<td>Men 25 years and over</td>
<td>1.8</td>
<td>3.4</td>
<td>3.5</td>
<td>3.5</td>
</tr>
<tr>
<td>Women 20 years and over</td>
<td>3.7</td>
<td>5.5</td>
<td>5.7</td>
<td>5.8</td>
</tr>
<tr>
<td>Both sexes 16–19 years</td>
<td>12.2</td>
<td>17.2</td>
<td>17.2</td>
<td>16.9</td>
</tr>
<tr>
<td>Race:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>White</td>
<td>3.3</td>
<td>5.4</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Negro and other races</td>
<td>6.3</td>
<td>9.2</td>
<td>9.5</td>
<td>9.9</td>
</tr>
<tr>
<td>Occupation:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>White-collar workers</td>
<td>2.2</td>
<td>3.5</td>
<td>3.6</td>
<td>3.5</td>
</tr>
<tr>
<td>Blue-collar workers</td>
<td>4.3</td>
<td>7.5</td>
<td>7.5</td>
<td>7.3</td>
</tr>
<tr>
<td>Service workers</td>
<td>4.0</td>
<td>6.0</td>
<td>6.1</td>
<td>6.3</td>
</tr>
<tr>
<td>Other categories:</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State insured workers</td>
<td>2.4</td>
<td>4.4</td>
<td>3.8</td>
<td>4.2</td>
</tr>
<tr>
<td>Married men</td>
<td>1.6</td>
<td>3.2</td>
<td>3.2</td>
<td>3.2</td>
</tr>
<tr>
<td>Full-time workers</td>
<td>3.2</td>
<td>5.5</td>
<td>5.5</td>
<td>5.5</td>
</tr>
<tr>
<td>Part-time workers</td>
<td>6.4</td>
<td>8.4</td>
<td>8.9</td>
<td>8.7</td>
</tr>
</tbody>
</table>

1 Unemployment as a percent of civilian labor force in group specified.

Source: Department of Labor.
Chart 3

Unemployment Rates, 1971

NOTE: UNEMPLOYMENT RATES BY STATES ARE ESTIMATES, BASED ON PRELIMINARY DATA FOR THE FIRST 11 MONTHS OF 1971.
SOURCE: DEPARTMENT OF LABOR.
The average duration of unemployment continued to rise in 1971, moving up from about 9 weeks in 1970 to nearly 12 weeks in 1971. Toward the year's end, about 560,000 persons had been jobless for at least 6 months—the maximum period for unemployment insurance payments under regular programs. Many of the long-term unemployed were former aerospace and defense workers living in Washington, California, Massachusetts, and a number of other States that were heavily affected by reduced defense purchasing (Chart 3). Some additional income protection was provided to many of these workers under the provisions to extend unemployment benefits contained in the Employment Security Amendments of 1970. This Act, signed into law by the President on August 10, 1970, established a Federal-State program to provide up to 13 additional weeks of unemployment compensation when local or national unemployment became high. In all, 22 States established eligibility under the individual State program at some time during 1971. About 340,000 workers were drawing extended benefits at the peak. The extended benefits program became effective throughout the Nation in January 1972 because the national insured unemployment rate had been above 4.5 percent for 3 successive months.

Regular unemployment insurance programs continued to provide shorter-term income protection to experienced unemployed workers who had been jobless for shorter periods. An average of 2.1 million workers, the largest share of whom are men in the prime working age groups, drew weekly unemployment benefits averaging $54.50 under regular State unemployment insurance programs during 1971.

PRICES AND COSTS

At the start of 1971 there were signs that the fight against inflation was yielding tangible results, and there were expectations that it would continue to do so in the coming year. During 1970 both the wholesale price index and the consumer price index rose less than they had in 1969. Less pronounced than the moderation in the rise of all wholesale prices, but really more significant, was the slowdown in the rise of wholesale industrial prices. There was considerable slack in the economy. With activity recovering, prospects were good that there would be an improvement in productivity, the growth of which had lagged seriously in the 2 preceding years. Indeed, the rise in unit labor costs had already slowed significantly during 1970.

To be sure, the then current evidence and the prospects were by no means uniformly reassuring. The rise in the comprehensive GNP deflator increased sharply in the fourth quarter of 1970, after declining from a peak in mid-1969. And a slower rise in wage rates was yet to be seen. The automobile industry had just concluded a costly wage settlement that was followed by a sizable increase in prices, and the 3-year contracts in the can, aluminum, and steel industries were due to expire at varying times by the end of July.
Still the evidence at the beginning of 1971, viewed in the light of past experience, gave support to the conclusion that the disinflationary policies were bearing fruit.

**PRICES**

The behavior of prices from the end of 1970 to mid-August and especially after April heightened concern about inflation. Although the rise in consumer prices continued to decelerate for several months early in the year, it quickened in the spring, as did the rise in wholesale industrial prices (Charts 4 and 5). The evidence provided by the more comprehensive measures of price change, the GNP deflators, also suggested at least a partial setback to earlier progress.

No single price index can tell the whole story of price behavior. For this reason special indexes are reviewed below and after this a summary statement is given.

**Consumer Prices**

The consumer price index (CPI), which had increased at rates of 6.1 percent during 1969 and 5.5 percent during 1970, rose at a seasonally adjusted annual rate of 2.8 percent in the first quarter of 1971 (Chart 4). The 1970 improvement had been due mainly to a slower rise in food prices. The further slowdown in early 1971, however, reflected a much reduced rate of increase for nonfood commodity prices, which in the past had displayed a cyclical behavior but during 1970 had failed to decelerate. Lower interest rates on mortgages were also important in the first-quarter slowdown.

The improvement proved to be short-lived as the second quarter brought a rise of 5.3 percent (annual rate) in the CPI. Not only was there some stepup in the rise of food prices, but nonfood commodities also rose more rapidly, at about their 1970 rate, while mortgage interest rates leveled out. Prices in July and August rose less rapidly than in the second quarter; the slowdown was especially pronounced for food, but it was also evident for nonfood commodities.

The behavior of the CPI, excluding mortgage interest and food, has a special interest because the short-term movements of food prices are exceptionally sensitive to changes in supply as well as demand and because mortgage interest costs are governed by factors rather different from those influencing most other prices. This calculation also shows a slower rise in the first quarter of 1971 as compared to 1970, a setback in the second quarter and a slowdown from June to August (Table 6).

**Wholesale Prices**

Mainly because of pronounced declines in farm prices, the rise in the wholesale price index (WPI) slowed considerably from 1969 to 1970—from 4.8 percent during 1969 to 2.2 percent during 1970. Conversely, in the first half of 1971, a strong recovery in farm prices was mainly responsible for the acceleration to a 5.0-percent rate of increase.
Chart 4

Changes in Consumer Prices

PERCENTAGE CHANGE FROM 6 MONTHS EARLIER

SERVICES

ALL ITEMS

FOOD

NONFOOD COMMODITIES

1/SEASONALLY ADJUSTED ANNUAL RATES
2/CHANGES BASED ON UNADJUSTED INDEXES SINCE THESE PRICES HAVE LITTLE SEASONAL MOVEMENT.
SOURCE: DEPARTMENT OF LABOR.


42
The industrial component of wholesale prices, representing nearly three-fourths of the weight of the WPI, is more significant as an index of the underlying inflationary trend because it is little influenced by short-run supply fluctuations. There had been some progress in restraining industrial prices. After rising 3.9 percent during 1969, they rose 3.6 percent during 1970, and in the first quarter of 1971 a further deceleration was apparent. However, this improvement was reversed in the second quarter. Industrial prices rose at a seasonally adjusted annual rate of 5.3 percent and then at a much faster rate in July and August. In general, the quarterly pattern of price change by major industry groups was very diverse and one cannot easily categorize the industries showing the largest increases (Chart 5).

**GNP Deflators**

The broadest measure of price change is the implicit GNP deflator, which is obtained as a by-product of the calculation of real output. A related measure is the deflator for gross private product; this excludes the pay of government workers and thus their pay raises, which have often distorted the interpretation of the behavior of overall prices because the raises have come at irregular intervals, and because no allowance is made in the accounting for increased productivity of government workers. Unlike commonly used indexes such as the CPI and the WPI, whose movements reflect price changes of fixed bundles of goods and services, movements in the implicit deflators reflect not only price changes but also shifts in the composition of output, which are sometimes very pronounced. To abstract from the effect of changes in the composition of output the Commerce Department has calculated alternative deflators; some use fixed 1967 weights, and others are chain indexes utilizing weights of the preceding quarter. Some of these measures appear in Table 7. All show some progress toward lower rates of inflation around the second or third quarters of 1970, some setback

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**Table 6.—Changes in consumer prices for all items and all items less food and mortgage interest, December 1968 to August 1971**

<table>
<thead>
<tr>
<th>Period</th>
<th>Percentage change</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>All items</td>
<td>All items less food and mortgage interest costs</td>
</tr>
<tr>
<td>December 1968 to December 1969</td>
<td>6.1</td>
<td>5.2</td>
</tr>
<tr>
<td>December 1969 to December 1970</td>
<td>5.5</td>
<td>5.9</td>
</tr>
<tr>
<td>December 1970 to March 1971</td>
<td>2.8</td>
<td>3.8</td>
</tr>
<tr>
<td>March 1971 to June 1971</td>
<td>5.3</td>
<td>6.2</td>
</tr>
<tr>
<td>June 1971 to August 1971</td>
<td>3.3</td>
<td>2.5</td>
</tr>
</tbody>
</table>

Source: Department of Labor.
Chart 5

Changes in Wholesale Prices

PERCENTAGE CHANGE FROM 6 MONTHS EARLIER/

ALL COMMODITIES

1/SEASONALLY ADJUSTED ANNUAL RATES.
SOURCE: DEPARTMENT OF LABOR.
in late 1970 and early 1971, and varying degrees of improvement from the setbacks in the second quarter of 1971.

**Summary of Price Behavior**

Chart 6 summarizes the behavior of several price measures in order to describe the progress against inflation prior to the freeze. Six measures have been selected, all but one of which—the GNP price deflator for personal consumption expenditures—have already been discussed. These indexes have all been computed quarterly, and in all cases the measure used is a base-weighted index. The charts illustrate calendar quarter-to-quarter changes, calculated at seasonally adjusted annual rates.

An examination of Chart 6 indicates the following: (1) Most of the indexes show a peak rate of increase at some time in 1969; (2) most of the indexes show a trough at some time in 1970; (3) in the second quarter of 1971, the last full quarter before the freeze, we find that the rate of increase is above the trough in all instances but below the peak in all but one instance—wholesale industrial prices. That, of course, is a serious exception. Although it does not negate the improvement shown in the other indexes, the exception was important enough and the other improvements small enough to leave uncertainty about the future decline of inflation.

**COMPENSATION AND WAGES**

Increases in average hourly compensation in the private nonfarm sector accelerated sharply from late 1965 until 1968, then leveled off at an average annual rate of increase of about 7 percent until the freeze was instituted in August 1971. A careful examination of these data on a quar-

---

**Table 7.—Alternative measures of price changes for gross national product and gross private product, 1968 I to 1971 IV**

<table>
<thead>
<tr>
<th>Quarter</th>
<th>Gross national product</th>
<th>Gross private product</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Implicit deflator</td>
<td>1967 weights</td>
</tr>
<tr>
<td>1968: I</td>
<td>3.6</td>
<td>3.9</td>
</tr>
<tr>
<td></td>
<td>3.9</td>
<td>4.5</td>
</tr>
<tr>
<td></td>
<td>4.3</td>
<td>4.7</td>
</tr>
<tr>
<td></td>
<td>4.6</td>
<td>4.6</td>
</tr>
<tr>
<td>1969: I</td>
<td>4.5</td>
<td>4.7</td>
</tr>
<tr>
<td></td>
<td>5.3</td>
<td>5.1</td>
</tr>
<tr>
<td></td>
<td>6.1</td>
<td>6.6</td>
</tr>
<tr>
<td></td>
<td>4.8</td>
<td>4.8</td>
</tr>
<tr>
<td>1970: I</td>
<td>6.6</td>
<td>5.9</td>
</tr>
<tr>
<td></td>
<td>4.6</td>
<td>5.1</td>
</tr>
<tr>
<td></td>
<td>5.0</td>
<td>4.8</td>
</tr>
<tr>
<td></td>
<td>6.3</td>
<td>5.3</td>
</tr>
<tr>
<td>1971: I</td>
<td>5.4</td>
<td>6.8</td>
</tr>
<tr>
<td></td>
<td>4.2</td>
<td>4.9</td>
</tr>
<tr>
<td></td>
<td>2.5</td>
<td>3.4</td>
</tr>
<tr>
<td></td>
<td>1.5</td>
<td>2.2</td>
</tr>
</tbody>
</table>

1 Weighted by quarter preceding quarter shown.  
2 Preliminary.  
Source: Department of Commerce.

| 451–688 0—72—4 |
Chart 6

Changes in Selected Price Measures

PERCENTAGE CHANGE FROM PRECEDING QUARTER

GNP PRICE INDEX
(1967 WEIGHTS)

PRIVATE GNP PRICE INDEX
(1967 WEIGHTS)

PERSONAL CONSUMPTION EXPENDITURES PRICE INDEX
(1967 WEIGHTS)

1/SEASONALLY ADJUSTED ANNUAL RATES
*LAST QUARTER BEFORE NEW ECONOMIC POLICY.
SOURCE: DEPARTMENT OF COMMERCE.
Chart 6

Changes in Selected Price Measures

PERCENTAGE CHANGE FROM PRECEDING QUARTER/

WHOLESALE PRICES—ALL COMMODITIES

WHOLESALE PRICES—INDUSTRIAL COMMODITIES

CONSUMER PRICES

1/SEASONALLY ADJUSTED ANNUAL RATES.
*LAST QUARTER BEFORE NEW ECONOMIC POLICY.
SOURCE: DEPARTMENT OF LABOR.
quarterly basis does not reveal any clear sign of a slowdown in compensation growth. To have halted the acceleration in the rise of hourly compensation was an accomplishment, but as long as increases of 7 percent persisted, there would be a continuation of considerable price inflation.

Historically, increases in hourly compensation have slowed significantly during periods of slack economic activity (Table 8), mainly but not exclu-

**Table 8.**—Rates of increase of hourly compensation during expansions and recessions, 1947 IV to 1970 IV

<table>
<thead>
<tr>
<th>Cyclic turning points ²</th>
<th>Private nonfarm economy</th>
<th>Manufacturing</th>
</tr>
</thead>
<tbody>
<tr>
<td>Peak</td>
<td>Trough</td>
<td>Year before peak to peak</td>
</tr>
<tr>
<td>1948: IV...</td>
<td>1949: IV...</td>
<td>8.0</td>
</tr>
<tr>
<td>1953: II...</td>
<td>1954: III...</td>
<td>6.0</td>
</tr>
<tr>
<td>1957: III...</td>
<td>1958: II...</td>
<td>5.4</td>
</tr>
<tr>
<td>1960: II...</td>
<td>1961: I...</td>
<td>4.3</td>
</tr>
<tr>
<td>1969: IV...</td>
<td>1970: IV...</td>
<td>6.5</td>
</tr>
</tbody>
</table>

² Hourly compensation estimates include salaries, wages, and supplemental benefits, for all workers, including the self-employed.

² Quarter designated as cyclical turning point by National Bureau of Economic Research.

Source: Department of Labor (except as noted).

sively as a result of cyclical reductions of overtime and a shift in the mix of employment away from high-wage industries. Such a respite was anticipated for 1970 but did not materialize either then or in 1971. As is indicated further on, the underlying causes of this continued rapid rate of increase are not clear. A technical factor that has hindered an understanding of wage developments has been the lack of comprehensive time series data on wage and salary rates. However, the information that is available suggests that average increases in wage and salary rates remained high for most occupation groups in most industries until mid-August.

Figures on average hourly earnings are available for production and nonsupervisory workers in private nonfarm industries, a group that accounts for over four-fifths of all employees in the private sector. These data can be adjusted so that they more nearly approximate average wage rates by eliminating both the effects of employment shifts between high- and low-wage industries and the effects of overtime changes (the latter adjustment is carried out only for manufacturing). The adjusted earnings increased nearly 7 percent during the year ending in the third quarter, about the same rate as in the 2 preceding years (Table 9). Although different patterns were evident among the individual industries, rates of increase in adjusted hourly earnings for all these broad industry groups were above 6 percent, an indication of the pervasiveness of the wage spiral. In the trade, finance, and services industries, where wage rates have ordinarily been more
Table 9.—Changes in adjusted average hourly earnings of private nonfarm production or nonsupervisory workers, 1968 III to 1971 III

<table>
<thead>
<tr>
<th>Industry</th>
<th>Percentage change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Private nonfarm industries</td>
<td></td>
</tr>
<tr>
<td>Mining</td>
<td>6.6</td>
</tr>
<tr>
<td>Construction</td>
<td>7.9</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>9.2</td>
</tr>
<tr>
<td>Transportation and public utilities</td>
<td>6.2</td>
</tr>
<tr>
<td>Wholesale and retail trade</td>
<td>6.2</td>
</tr>
<tr>
<td>Finance, insurance, and real estate</td>
<td>6.4</td>
</tr>
<tr>
<td>Services</td>
<td>5.4</td>
</tr>
<tr>
<td></td>
<td>6.5</td>
</tr>
</tbody>
</table>

1 Adjusted for interindustry shifts, and for manufacturing for overtime also.
Source: Department of Labor.

Sensitive to the business cycle, hourly earnings continued to advance rapidly, despite ample supplies of labor and the relatively mild expansion of demand.

Statistics on negotiated wage rate changes are available for workers covered by large collective bargaining agreements. Wage increases negotiated in major collective bargaining agreements in the first 3 quarters of 1971 averaged a bit less than in 1970 (Table 10). However, these average changes are significantly affected by the mix of industries and by the unions involved in bargaining. Moreover, they exclude the potential effects of wage increase

Table 10.—Wage rate increases in major collective bargaining agreements, 1969–71

<table>
<thead>
<tr>
<th>Item</th>
<th>Mean percentage increase</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1969</td>
</tr>
<tr>
<td>Negotiated annual wage rate increases averaged over life of contract:</td>
<td></td>
</tr>
<tr>
<td>All industries</td>
<td>7.6</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>6.0</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>9.3</td>
</tr>
<tr>
<td>Construction</td>
<td>13.1</td>
</tr>
<tr>
<td>Other</td>
<td>7.4</td>
</tr>
<tr>
<td>Negotiated first-year wage-rate increases:</td>
<td></td>
</tr>
<tr>
<td>All industries</td>
<td>9.2</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>7.9</td>
</tr>
<tr>
<td>Nonmanufacturing</td>
<td>10.8</td>
</tr>
<tr>
<td>Construction</td>
<td>13.1</td>
</tr>
<tr>
<td>Other</td>
<td>9.6</td>
</tr>
<tr>
<td>General wage increases in manufacturing: 1</td>
<td></td>
</tr>
<tr>
<td>Union establishments</td>
<td>7.4</td>
</tr>
<tr>
<td>Nonunion establishments</td>
<td>6.1</td>
</tr>
</tbody>
</table>

1 Data relate only to establishments in which a decision was made to increase wages.
Note.—Data relate to contracts covering 1,000 workers or more and exclude possible increases in wages from cost-of-living escalator clauses except where guaranteed.
Source: Department of Labor.
agreements with open-ended cost-of-living escalator clauses. In 1971, there was a large increase in the number of workers covered by such cost-of-living escalator clauses, although the total number so covered remains a small proportion of the work force. Much of the slowing in the rate of increase for negotiated wage rates in 1971 occurred in the construction industry, apparently as a consequence of actions of the Construction Industry Stabilization Committee (see Chapter 2).

Collective bargaining agreements in manufacturing provided larger wage increases in 1971 than in 1970, with average first-year wage increases accelerating from 8.1 percent in 1970 to 10.7 percent in the first 9 months of 1971. Since 1965, average wage increases have been larger in nonmanufacturing industries than in manufacturing. Efforts of manufacturing workers to reverse this pattern, to regain old wage differentials, and to obtain gains more nearly like those in the transportation and construction industries were partly responsible for the acceleration in manufacturing.

Data for manufacturing point to differences in wage behavior between nonunion and union firms. Among nonunion establishments that made decisions to raise wages in the first 3 quarters of 1971, the increases were a little less than in 1970. Union establishments, however, granted much larger increases than those of the year before. Nonunion wage rates appeared to be responding more promptly to the weakness in labor demand, just as they had responded more promptly to the inflation that gained headway after 1965. At that time nonunion wage rates rose more sharply than union wages.

Some statistics are also available on changes in salary rates in quite narrowly classified white-collar occupation groups. To judge from these data, the rise in salary rates accelerated further in 1971, even though unemployment in most of these occupations had risen in 1970 and remained high in 1971 (Table 11).

Thus, although our statistics on wage and salary rates and changes are imperfect, it appeared in the summer of 1971 that the expected slowdown in wage and salary increases had not materialized. On the contrary, increases were persisting at an inflationary pace.

### Table 11.—Rise of white-collar salaries, selected occupations in private industry, 1961 to 1971

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>White-collar workers</td>
<td>3.1</td>
<td>4.5</td>
<td>5.4</td>
<td>5.7</td>
<td>6.2</td>
<td>6.6</td>
</tr>
<tr>
<td>Professional, administrative, and technical</td>
<td>3.4</td>
<td>4.2</td>
<td>5.5</td>
<td>5.8</td>
<td>6.2</td>
<td>6.7</td>
</tr>
<tr>
<td>Clerical</td>
<td>2.7</td>
<td>4.8</td>
<td>5.3</td>
<td>5.5</td>
<td>6.2</td>
<td>6.5</td>
</tr>
</tbody>
</table>

Note.—Changes are based on data for June of each year and relate to weighted averages of a cross section of representative occupations (subdivided into levels of responsibility) designed to compare Federal pay with private pay.

Source: Department of Labor.
PRODUCTIVITY AND LABOR COSTS

The rise in output from the third quarter of 1970 to the third quarter of 1971 was accompanied by a slight decline in man-hours of work. The resulting rise in productivity—output per man-hour—was an extension of an upturn that began after the first quarter of 1970, and followed 2 years in which output per man-hour was essentially unchanged (Chart 7). From then until the third quarter of 1971, output per man-hour in the private nonfarm economy increased at an annual rate of 2.5 percent. This did not make up the earlier shortfall from trend.

The pattern of productivity change described above was broadly consistent with patterns during previous business cycles, although there were some significant differences. First, the period of no appreciable increase in average output per man-hour was unusually long—nearly 2 years. In the first part of this period, from roughly mid-1968 to the summer of 1969, employers increased their employment rolls rapidly even though the rise in output was slowing down. That period was one of low unemployment and high labor turnover, one also in which employers seemed to be engaged in labor hoarding because of their expectations of rising demand and difficulties in hiring experienced help. An extended interval of insignificant productivity growth while output is still rising is not a characteristic of cyclical experience. In the second part of the period, output declined while work forces continued to expand until early 1970, and then were maintained or cut very little. Developments of this kind have been observed in other mild recessions.

Second, after 3 quarters of output growth total man-hours remained about unchanged instead of rising, as in previous recoveries. The failure of man-hours to rise probably reflected a heightened emphasis on cost control resulting from the continuing profit squeeze and the mild recovery of output.

With the rise in hourly rates of compensation holding steady, the upturn in productivity growth moderated the rise in unit labor costs. After having risen at an annual rate of 6.5 percent during the 2 previous years, unit labor costs rose at a rate of 3.9 percent from the third quarter of 1970 to the third quarter of 1971 (Table 12).

CORPORATE COSTS AND PRICES

The labor costs discussed above are not the full story of cost inflation. Data pertaining to nonfinancial corporations provide a useful framework for breaking down the price of output into labor costs, nonlabor costs (depreciation, indirect business taxes, and net interest), and profits. This particular sector of the economy accounts for a large proportion of the Nation's output, constituting 60 percent of private GNP in 1971. A special advantage of analyzing corporate data is that the line between wages and salaries on the one hand and profits on the other is fairly distinct, whereas in the noncorporate sector the income earned by a partner or sole proprietor is a mixture of labor and property income.
Chart 7

Changes in Compensation, Productivity, Labor Costs, and Prices
Private Nonfarm Sector

PERCENTAGE CHANGE FROM PRECEDING YEAR

COMPENSATION PER MAN- HOUR

OUTPUT PER MAN- HOUR

UNIT LABOR COSTS

PRICES


NOTE: DATA RELATE TO ALL PERSONS.
SOURCE: DEPARTMENT OF LABOR.
In the short run prices are viewed as being responsive to total costs as well as to demand, but a rise in a particular component of cost does not necessarily mean a rise in price. For example, a rise in depreciation costs may reflect a substitution of capital for labor which has the net result of leaving total costs unchanged.

From the third quarter of 1970 to the third quarter of 1971, the price of corporate output rose 4.2 percent, a little more than in 1970 and considerably more than in any one of the 3 years preceding 1970. The rise in total costs slowed, and profits before taxes per unit of output rose 8.6 percent, or 10.2 percent if allowance is made for the liberalization in depreciation. Despite the increase, unit profits were extremely low by post-war standards.

Unit costs of all types rose less rapidly during 1971 than the year before, but the slowdown in nonlabor costs was less than that of labor costs (Table 13). The rise in capital consumption allowances per unit during the past year was partly influenced by the more liberal depreciation permitted by the Treasury in 1971. Because of changing regulations affecting depreciation, and the use of historical costs in calculating depreciation, changes in this component of costs are difficult to interpret. One cannot infer that a rise in measured depreciation costs means a more rapid using up of the stock of physical capital held by nonfinancial corporations.

When corporate output fell in 1970, indirect business taxes accounted for a rising share of total price. To some extent this was a cyclical response, since some of these taxes are relatively fixed and their share increases as volume declines. The increase in output in 1971 was too small to keep these costs from rising still more, despite the decline in taxes due to the elimination of the excise tax on motor vehicles.

Interest costs per unit rose less rapidly last year, partly because the decline in interest rates slowed the rise in the effective interest charge paid on all nonfinancial corporate indebtedness.
### Table 13.—Changes in prices, costs, and profits per unit of output for nonfinancial corporations, 1966 III to 1971 III

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Dollar change per unit of output:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price</td>
<td>0.031</td>
<td>0.029</td>
<td>0.036</td>
<td>0.048</td>
<td>0.051</td>
</tr>
<tr>
<td>Total costs</td>
<td>0.044</td>
<td>0.028</td>
<td>0.061</td>
<td>0.062</td>
<td>0.041</td>
</tr>
<tr>
<td>Employee compensation</td>
<td>0.028</td>
<td>0.020</td>
<td>0.044</td>
<td>0.038</td>
<td>0.021</td>
</tr>
<tr>
<td>Other costs</td>
<td>0.016</td>
<td>0.008</td>
<td>0.017</td>
<td>0.024</td>
<td>0.020</td>
</tr>
<tr>
<td>Capital consumption allowances</td>
<td>0.008</td>
<td>0.001</td>
<td>0.007</td>
<td>0.012</td>
<td>0.010</td>
</tr>
<tr>
<td>Indirect business taxes 1</td>
<td>0.005</td>
<td>0.005</td>
<td>0.004</td>
<td>0.008</td>
<td>0.007</td>
</tr>
<tr>
<td>Interest</td>
<td>0.003</td>
<td>0.002</td>
<td>0.006</td>
<td>0.004</td>
<td>0.003</td>
</tr>
<tr>
<td>Profits 2</td>
<td>-0.014</td>
<td>0.002</td>
<td>-0.026</td>
<td>-0.013</td>
<td>0.011</td>
</tr>
<tr>
<td>Percentage change per unit of output:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Price</td>
<td>2.9</td>
<td>2.6</td>
<td>3.2</td>
<td>4.1</td>
<td>4.2</td>
</tr>
<tr>
<td>Total costs</td>
<td>4.9</td>
<td>3.0</td>
<td>6.3</td>
<td>6.0</td>
<td>3.8</td>
</tr>
<tr>
<td>Employee compensation</td>
<td>4.1</td>
<td>2.8</td>
<td>6.0</td>
<td>4.9</td>
<td>2.6</td>
</tr>
<tr>
<td>Other costs</td>
<td>7.4</td>
<td>3.4</td>
<td>7.1</td>
<td>9.3</td>
<td>7.1</td>
</tr>
<tr>
<td>Capital consumption allowances</td>
<td>8.0</td>
<td>9.0</td>
<td>6.4</td>
<td>10.3</td>
<td>7.8</td>
</tr>
<tr>
<td>Indirect business taxes 1</td>
<td>5.2</td>
<td>5.9</td>
<td>3.8</td>
<td>7.3</td>
<td>5.9</td>
</tr>
<tr>
<td>Interest</td>
<td>15.6</td>
<td>8.7</td>
<td>28.0</td>
<td>12.9</td>
<td>8.9</td>
</tr>
<tr>
<td>Profits 2</td>
<td>-7.8</td>
<td>1.2</td>
<td>-15.6</td>
<td>-9.2</td>
<td>8.6</td>
</tr>
<tr>
<td>Output</td>
<td>1.0</td>
<td>7.0</td>
<td>3.3</td>
<td>-1.2</td>
<td>2.1</td>
</tr>
</tbody>
</table>

1 Also includes business transfer payments less subsidies. 2 Before taxes and including inventory valuation adjustment.

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

**Source:** Department of Commerce.

### Cost and Profit Shares

Table 14 shows the distribution of gross product originating in non-financial corporations. The profit share in 1971 (before taxes and including the inventory valuation adjustment) was 11.0 percent, up from the very low 10.3 percent for 1970, but well below the 15.1-percent average from 1960 to 1969. Without the new 1971 depreciation regulations, the profit share would have been only slightly higher at 11.2 percent.

The profit share is sensitive to the stage of the business cycle, and one reason for the present low share is that the economy is operating considerably below capacity. As noted above, changing depreciation regulations also affect the profit share, but this can be remedied if depreciation is calculated on a uniform basis. The Commerce Department has done this in special calculations, shown below on line 2 for selected high-employment years and the more recent period. On this basis the decline in the profit share from 1948 is less than the decline in the reported share, but the decline since 1956 is the same on the two bases.

A comprehensive analysis of property income requires consideration of interest charges, which have become substantially more important in post-war years. When the interest share is combined with the adjusted profit
**TABLE 14.—Distribution of gross product originating in nonfinancial corporations, 1947-71**

(Percent)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total</th>
<th>Compensation of employees</th>
<th>All other costs</th>
<th>Profits 1</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>Total</td>
<td>Capital consumption allowances</td>
</tr>
<tr>
<td>1947</td>
<td>100.0</td>
<td>65.9</td>
<td>14.8</td>
<td>4.8</td>
</tr>
<tr>
<td>1948</td>
<td>100.0</td>
<td>63.9</td>
<td>14.5</td>
<td>5.0</td>
</tr>
<tr>
<td>1949</td>
<td>100.0</td>
<td>63.8</td>
<td>16.1</td>
<td>5.9</td>
</tr>
<tr>
<td>1950</td>
<td>100.0</td>
<td>62.4</td>
<td>15.5</td>
<td>5.7</td>
</tr>
<tr>
<td>1951</td>
<td>100.0</td>
<td>63.1</td>
<td>15.1</td>
<td>5.8</td>
</tr>
<tr>
<td>1952</td>
<td>100.0</td>
<td>64.8</td>
<td>16.1</td>
<td>6.2</td>
</tr>
<tr>
<td>1953</td>
<td>100.0</td>
<td>65.9</td>
<td>16.6</td>
<td>6.6</td>
</tr>
<tr>
<td>1954</td>
<td>100.0</td>
<td>65.9</td>
<td>17.6</td>
<td>7.7</td>
</tr>
<tr>
<td>1955</td>
<td>100.0</td>
<td>63.9</td>
<td>17.5</td>
<td>7.9</td>
</tr>
<tr>
<td>1956</td>
<td>100.0</td>
<td>65.3</td>
<td>17.7</td>
<td>8.0</td>
</tr>
<tr>
<td>1957</td>
<td>100.0</td>
<td>65.6</td>
<td>18.6</td>
<td>8.4</td>
</tr>
<tr>
<td>1958</td>
<td>100.0</td>
<td>65.9</td>
<td>19.9</td>
<td>9.1</td>
</tr>
<tr>
<td>1959</td>
<td>100.0</td>
<td>64.7</td>
<td>19.1</td>
<td>8.7</td>
</tr>
<tr>
<td>1960</td>
<td>100.0</td>
<td>65.5</td>
<td>19.7</td>
<td>8.9</td>
</tr>
<tr>
<td>1961</td>
<td>100.0</td>
<td>65.1</td>
<td>20.4</td>
<td>9.2</td>
</tr>
<tr>
<td>1962</td>
<td>100.0</td>
<td>64.3</td>
<td>20.8</td>
<td>9.7</td>
</tr>
<tr>
<td>1963</td>
<td>100.0</td>
<td>63.9</td>
<td>20.9</td>
<td>9.7</td>
</tr>
<tr>
<td>1964</td>
<td>100.0</td>
<td>63.3</td>
<td>20.8</td>
<td>9.5</td>
</tr>
<tr>
<td>1965</td>
<td>100.0</td>
<td>62.6</td>
<td>20.4</td>
<td>9.4</td>
</tr>
<tr>
<td>1966</td>
<td>100.0</td>
<td>63.2</td>
<td>20.0</td>
<td>9.3</td>
</tr>
<tr>
<td>1967</td>
<td>100.0</td>
<td>64.0</td>
<td>20.9</td>
<td>9.7</td>
</tr>
<tr>
<td>1968</td>
<td>100.0</td>
<td>64.2</td>
<td>21.2</td>
<td>9.7</td>
</tr>
<tr>
<td>1969</td>
<td>100.0</td>
<td>65.8</td>
<td>21.8</td>
<td>9.9</td>
</tr>
<tr>
<td>1970</td>
<td>100.0</td>
<td>66.7</td>
<td>23.0</td>
<td>10.5</td>
</tr>
<tr>
<td>1971</td>
<td>100.0</td>
<td>65.5</td>
<td>23.5</td>
<td>10.7</td>
</tr>
</tbody>
</table>

1 Also includes business transfer payments less subsidies.
2 Before taxes and including inventory valuation adjustment.
3 Preliminary.

Note.—Detail will not necessarily add to totals because of rounding.
Source: Department of Commerce.

share, the total property share appears to have declined from earlier years, but less than the share of reported profits alone.

**[Percent of gross product of nonfinancial corporations]**

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>(1) Reported profits</td>
<td>21.6</td>
<td>16.9</td>
<td>17.0</td>
<td>14.7</td>
<td>12.4</td>
<td>10.3</td>
</tr>
<tr>
<td>(2) Adjusted profits</td>
<td>21.7</td>
<td>18.2</td>
<td>18.4</td>
<td>16.0</td>
<td>13.7</td>
<td>11.7</td>
</tr>
<tr>
<td>(3) Net interest</td>
<td>22.4</td>
<td>18.9</td>
<td>20.0</td>
<td>18.2</td>
<td>16.3</td>
<td>14.6</td>
</tr>
</tbody>
</table>

**INCOMES IN AGRICULTURE**

Agricultural incomes often fluctuate widely from year to year for reasons only partially related to output and price developments in the general economy. The demand for farm products is relatively insensitive to changes in overall output and prices. Farm prices, therefore, fluctuate primarily in response to supply conditions for agricultural products. On the other hand, since many farm inputs are purchased from the nonfarm sector, price increases in the nonfarm economy have a direct impact on farm production costs.
In the past 3 years, farm production expenses have been increasing at a
slightly faster pace than the general rate of inflation, reflecting primarily
higher input prices but also some increases in quantities of inputs purchased.
During this period, the value of farm sales increased 9.1 percent in 1969,
only 2.3 percent in 1970 and 4.9 percent in 1971. Net income of farm oper-
ators increased sharply in 1969—to the highest levels in over 20 years—and
then declined in 1970. According to preliminary estimates net income (in-
cluding increases in the value of yearend inventories) recovered slightly in
1971. The pattern of the 1970 decline and 1971 recovery has also been
significant. Income of farm operators declined in each consecutive quarter
through 1970 and improved in each quarter of 1971. The improvement was
particularly strong in the second half of last year.

Aggregate measures do not give a complete picture of recent changes in
the income situation of farm families. Because of the continuing secular
decline in farm numbers, average net income per farm declined only
slightly in 1970 and the 1971 recovery returned it to the record level of 1969.
This indicator is also imperfect because the current census definition of a
farm includes many places only nominally engaged in farming. Many peo-
ple who are counted as living on farms are primarily dependent on nonfarm
earnings; others supplement their farm income with nonfarm work. Earn-
ings from nonfarm sources by the farm population have been increasing
regularly for many years and in 1971 they constituted over 48 percent of
the farm population’s total personal income. Because the growth in nonfarm
jobs has been limited, income from this source has expanded at a slower
rate the last 2 years than in earlier years.

FINANCIAL POLICY AND FINANCIAL MARKETS

The economic goals of 1971 required considerable aid from monetary
policy. In the first half of the year monetary growth proceeded at very high
rates, but expansive effects upon the economy normally associated with such
rapid growth in money were not forthcoming. This shortfall from expecta-
tions came about because a large part of the increase in the money stock went
to satisfy an increased desire by the public for money balances. The year
1971 saw generally lower interest rates than 1970, and sectors sensitive to
the costs of credit, particularly housing, enjoyed a considerable expansion.

MONETARY POLICY

The Federal Reserve’s stated goals of monetary policy in 1971 were “the
resumption of sustainable economic growth, while encouraging an orderly
reduction in the rate of inflation, moderation of short-term capital outflows,
and attainment of reasonable equilibrium in the country’s balance of pay-
ments.” After August 15 the success of the New Economic Policy became
one more goal of monetary policy. Throughout the year the Federal Reserve
sought monetary growth rates that would best bring about attainment of
these goals.
At the beginning of 1971 there was concern that monetary growth in the last quarter of 1970 had been less than desirable. The growth rate for the money supply (currency and demand deposits) or M₁ during that quarter appeared at that time to have been about 3½ percent at a seasonally adjusted annual rate (measured from the final month of the third quarter to the final month of the fourth quarter), and it was decided that a rate of growth of about 7½ percent in the first quarter of 1971 would compensate for this shortfall. Policy in January was thus directed at attaining “some moderate easing of money market conditions.” Accordingly, open market operations were aimed at lowering market interest rates. As the quarter progressed, preliminary reports showed that the money stock was not growing as rapidly as the Federal Reserve’s analysis had predicted it would under the attained money market conditions, and greater ease was sought.

In the second quarter revised data showed that the money stock had in fact grown faster than had been anticipated. Because this was faster than desired, policy was then directed at slowing the monetary growth rate. To this end temporary “minor firming of money market conditions” was sought, and market interest rates increased. Nevertheless the rate of monetary growth in the second quarter exceeded the rate in the first quarter, despite an increase in interest rates. For the 2 quarters combined, monetary growth was very high, even after allowance for the shortfall in the fourth quarter of 1970. From December 1970 to June 1971, the money stock rose at a seasonally adjusted annual rate of 10.2 percent, and the broadly defined money stock that includes all time deposits at commercial banks except large certificates of deposit (M₂) climbed at a seasonally adjusted annual rate of 16.1 percent. These were high, not only compared to 1970 but compared to the preceding decade. During 1970, M₁ had risen at a 5.4-percent rate, M₂ at an 8.1-percent rate. In the 7 years ending December 1970, the average annual rates of growth were 4.9 and 7.2 percent, respectively.

In June, the Federal Reserve showed less explicit concern with money market conditions and continued its effort to moderate monetary growth rates. Although in July the money stock continued to grow rapidly despite a considerable rise in interest rates, in August the rates of expansion for both M₁ and M₂ fell sharply and the rate for M₁ turned negative in September. The rise in M₁ came to 3.8 percent for the third quarter as a whole. In contrast to the first half of the year, the Federal Reserve at this time overestimated the monetary expansion resulting from the money market conditions that had been produced.

Despite the stated policy to place emphasis on the monetary growth rate in 1971, actual operations were designed to influence interest rates and conditions in short-term money markets, with the intention of thereby achieving the desired monetary growth rate. In practice the Federal Reserve operated most directly on the interest rate on loans among banks, called the Federal funds rate, relying on its appraisal of how monetary growth rates would respond to various levels of the interest rate. If the money stock
responded to the Federal funds rate in a way that differed from the expected response, the monetary growth rate would differ from that desired.

In the first half of 1971, the public apparently wanted to hold more money balances at the prevailing level of interest rates and income than past relations among income, interest rates, and money balances suggested. The bulk of the increases in money holdings appeared in individuals' accounts, and the pattern was part of a larger shift in the public's desire for additional financial liquidity in the first half of 1971. Table 15 shows that in

<table>
<thead>
<tr>
<th>Type of saving</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>1971</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I</td>
<td>II</td>
<td>III</td>
<td></td>
</tr>
<tr>
<td><strong>Seasonally adjusted annual rates</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total saving by individuals</td>
<td>63.5</td>
<td>56.1</td>
<td>71.4</td>
<td>87.7</td>
</tr>
<tr>
<td>Increase in financial assets</td>
<td>69.6</td>
<td>60.9</td>
<td>74.6</td>
<td>90.4</td>
</tr>
<tr>
<td>Currency and demand deposits</td>
<td>11.3</td>
<td>6.0</td>
<td>4.8</td>
<td>10.9</td>
</tr>
<tr>
<td>Savings accounts</td>
<td>28.6</td>
<td>13.3</td>
<td>32.2</td>
<td>97.9</td>
</tr>
<tr>
<td>Securities</td>
<td>4.0</td>
<td>16.7</td>
<td>8.4</td>
<td>-53.1</td>
</tr>
<tr>
<td>U.S. savings bonds</td>
<td>.4</td>
<td>-.4</td>
<td>.3</td>
<td>1.9</td>
</tr>
<tr>
<td>Other U.S. Treasury and agency securities</td>
<td>4.9</td>
<td>13.6</td>
<td>.0</td>
<td>-51.8</td>
</tr>
<tr>
<td>State and local obligations</td>
<td>.9</td>
<td>1.3</td>
<td>-1.5</td>
<td>.0</td>
</tr>
<tr>
<td>Corporate and foreign bonds</td>
<td>5.4</td>
<td>5.4</td>
<td>12.2</td>
<td>9.5</td>
</tr>
<tr>
<td>Investment company and other corporate shares</td>
<td>-7.5</td>
<td>-3.8</td>
<td>-2.6</td>
<td>-12.8</td>
</tr>
<tr>
<td>Insurance and pension reserves</td>
<td>25.7</td>
<td>25.3</td>
<td>29.2</td>
<td>34.7</td>
</tr>
<tr>
<td>Net investment in tangible assets</td>
<td>37.2</td>
<td>36.4</td>
<td>25.8</td>
<td>39.7</td>
</tr>
<tr>
<td>Less: Increase in debt</td>
<td>43.3</td>
<td>41.1</td>
<td>29.0</td>
<td>42.5</td>
</tr>
<tr>
<td>Mortgage debt on nonfarm houses</td>
<td>14.9</td>
<td>16.2</td>
<td>12.5</td>
<td>13.1</td>
</tr>
<tr>
<td>Noncorporate business mortgage debt</td>
<td>6.6</td>
<td>6.9</td>
<td>8.0</td>
<td>9.9</td>
</tr>
<tr>
<td>Consumer credit</td>
<td>11.1</td>
<td>9.3</td>
<td>4.3</td>
<td>4.0</td>
</tr>
<tr>
<td>Other debt</td>
<td>10.8</td>
<td>8.6</td>
<td>4.1</td>
<td>15.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>15.8</td>
</tr>
</tbody>
</table>

Note.—Detail will not necessarily add to totals because of rounding.
Source: Board of Governors of the Federal Reserve System.

the first half of 1971 unusually large increases occurred in individuals' hold-

ings of money, savings accounts, and U.S. savings bonds, while decreases or smaller than usual increases were recorded in their holdings of other U.S. Treasury and U.S. Government agency securities, corporate bonds, and corporate stock. This shift in the composition of assets was also influenced by the substantial decline in interest rates after mid-1970, especially in the rates on short-term securities.

The shift in assets by individuals in favor of more liquidity was accom-
ppanied by particularly large increases in debt incurred by the public, not-
ably in the form of mortgage and other personal debt. There were also important changes in the structure of business borrowing. As Table 16 shows, in the past year and a half corporations have shifted their financing toward equities and long-term bonds and away from bank loans and
### Table 16.—Sources and uses of funds, nonfarm nonfinancial corporate business, 1968–1971 III

<table>
<thead>
<tr>
<th>Source or use of funds</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>1971 III</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sources, total</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Internal sources</td>
<td>108.0</td>
<td>118.1</td>
<td>105.5</td>
<td>118.0</td>
</tr>
<tr>
<td>Stocks</td>
<td>61.7</td>
<td>59.5</td>
<td>61.5</td>
<td>68.3</td>
</tr>
<tr>
<td>Bonds</td>
<td>46.3</td>
<td>58.6</td>
<td>44.0</td>
<td>49.7</td>
</tr>
<tr>
<td>Mortgages</td>
<td></td>
<td></td>
<td></td>
<td>51.9</td>
</tr>
<tr>
<td>Bank loans</td>
<td></td>
<td></td>
<td></td>
<td>52.7</td>
</tr>
<tr>
<td>Trade debt</td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Other loans and liabilities</td>
<td></td>
<td></td>
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<td></td>
</tr>
<tr>
<td>Uses, total</td>
<td>101.7</td>
<td>112.7</td>
<td>103.7</td>
<td>109.6</td>
</tr>
<tr>
<td>Purchases of physical assets</td>
<td>76.1</td>
<td>84.9</td>
<td>84.2</td>
<td>83.8</td>
</tr>
<tr>
<td>Increase in financial assets</td>
<td>25.6</td>
<td>27.8</td>
<td>19.5</td>
<td>25.8</td>
</tr>
<tr>
<td>Liquid assets</td>
<td>8.6</td>
<td>1.3</td>
<td>8.9</td>
<td>3.0</td>
</tr>
<tr>
<td>Currency and demand deposits</td>
<td>1.6</td>
<td>-0.9</td>
<td>-1.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Time deposits</td>
<td>1.9</td>
<td>-9.8</td>
<td>12.8</td>
<td>3.0</td>
</tr>
<tr>
<td>U.S. Government securities</td>
<td>1.7</td>
<td>-1.7</td>
<td>-3.2</td>
<td>8.8</td>
</tr>
<tr>
<td>Open-market paper</td>
<td>4.4</td>
<td>8.6</td>
<td>-1.1</td>
<td>-7.3</td>
</tr>
<tr>
<td>State and local obligations</td>
<td>-1.1</td>
<td>5.1</td>
<td>1.4</td>
<td>6.1</td>
</tr>
<tr>
<td>Consumer credit</td>
<td>1.7</td>
<td>1.3</td>
<td>1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Trade credit</td>
<td>13.9</td>
<td>17.3</td>
<td>6.2</td>
<td>11.6</td>
</tr>
<tr>
<td>Other financial assets</td>
<td>1.4</td>
<td>8.0</td>
<td>3.0</td>
<td>9.6</td>
</tr>
<tr>
<td>Discrepancy (uses less sources)</td>
<td>-6.3</td>
<td>-5.4</td>
<td>1.8</td>
<td>-3.8</td>
</tr>
<tr>
<td>Seasonally adjusted annual rates</td>
<td>118.0</td>
<td>123.7</td>
<td>124.3</td>
<td></td>
</tr>
</tbody>
</table>

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

Source: Board of Governors of the Federal Reserve System.

short-term open market instruments. The shift of both individuals and corporations toward longer-term debt and shorter-term assets reflects in part a reaction to the period of restrictive credit conditions in 1969. In that year, business and individual borrowers had considerable difficulty obtaining funds at rates they deemed reasonable. As a result, they began insulating themselves from the pressures of credit markets when conditions eased in 1970 and 1971 by refunding short-term debt with long-term and rebuilding their holdings of liquid assets.

**INTEREST RATES**

With monetary policy more expansive and with growing sentiment that progress was being made against inflation, market interest rates early in 1971 continued their downward trends of the second half of 1970, reaching levels that turned out to be the lowest of the year (Table 17 and Chart 8). Fluctuations in long-term rates are typically smaller than in short-term, but the differential movement last spring also reflected in part the continued shift from short- to long-term financing by business borrowers, who were attempting to insulate their liquidity position.
TABLE 17.—Interest rates, 1970–71

<table>
<thead>
<tr>
<th>Type</th>
<th>1970</th>
<th>1971</th>
<th>Aug. 131</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High</td>
<td>End of year</td>
<td>Low</td>
</tr>
<tr>
<td></td>
<td>7.96 Jan. 5</td>
<td>4.83</td>
<td>3.31 Mar. 13</td>
</tr>
<tr>
<td>3-month Treasury bill rate (new issues)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>4-6 month prime commercial paper rate</td>
<td>9.13 Jan. 8</td>
<td>5.75</td>
<td>4.00 Mar. 24</td>
</tr>
<tr>
<td>Long-term taxable Treasury bond yield</td>
<td>7.15 June 12</td>
<td>6.16</td>
<td>5.40 Nov. 3</td>
</tr>
<tr>
<td>Corporate Aaa bond yield</td>
<td>8.60 July 2</td>
<td>7.48</td>
<td>7.05 Feb. 16</td>
</tr>
<tr>
<td>New Aaa corporate offering rate (weekly average)</td>
<td>9.30 June 19</td>
<td>7.68</td>
<td>6.76 Jan. 29</td>
</tr>
<tr>
<td>High-grade municipal bond yield (weekly)</td>
<td>7.14 May 29</td>
<td>5.81</td>
<td>5.14 Nov. 5</td>
</tr>
<tr>
<td>FHA new home mortgage yield</td>
<td>9.29 Mar.</td>
<td>8.90</td>
<td>7.32 Apr.</td>
</tr>
</tbody>
</table>

1 Rates for Aug. 13 or nearest date for which data are reported.

Sources: Board of Governors of the Federal Reserve System, Moody’s Investors Service, Standard & Poor’s Corporation, and Department of Housing and Urban Development.

After March, interest rates began rising as a result of the reversal of inflationary expectations and attempts by the Federal Reserve to curtail the monetary growth rate in the face of a shift in the demand for liquidity. By July many market rates had risen to roughly the levels prevailing in November and December 1970, but all remained below the 1970 peak levels.

Reintermediation

The year 1971 saw a continuation of the process of “reintermediation,” which had started in 1970 as a correction of the preceding year’s “disintermediation.”

Most thrift institutions are constrained in their ability to retain deposits during periods of rising interest rates. Because the yields on their assets, which are generally long term, change very slowly, it is difficult for them to change rates paid on their liabilities, which are generally short term. Partly in recognition of this problem, most of these institutions have regulatory ceilings on the rates they can pay on deposits. Under conditions of rising market interest rates, earnings on long-term assets would generally not rise quickly enough to enable institutions to pay rates on their deposits that would be competitive with unconstrained money market instruments. The rate ceilings also curtail the ability of institutions to retain funds. As a result, when interest rates rise very sharply, as they did in 1966 and 1969, financial intermediaries both lose funds and acquire fewer new funds, more of which are invested directly in primary assets, such as Treasury bills and bonds or municipal and corporate bonds. This process has been termed “disintermediation” and, as Table 18 shows, it occurred in 1969. In that year banks...
Chart 8

Interest Rates

PERCENT PER ANNUM

SHORT-TERM

FEDERAL RESERVE DISCOUNT RATE

PRIME COMMERCIAL PAPER

3-MONTH TREASURY BILLS (New Issues)

LONG-TERM

FHA NEW HOME MORTGAGES

CORPORATE Aaa BONDS

U.S. GOVERNMENT BONDS

HIGH-GRADE MUNICIPAL BONDS

SOURCES: DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, TREASURY DEPARTMENT, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S INVESTORS SERVICE, AND STANDARD & POOR'S CORPORATION
and other savings institutions experienced a $1.6 billion net decrease in total time and savings deposits, compared to a $33.4 billion rise in 1968.

Since short-term rates in the second half of 1970 and all of 1971 were generally below the high levels of 1969, this process of disintermediation was reversed. Table 18 shows that the net increase in the flow of total time and savings deposits through savings institutions in 1970 exceeded the 1968 levels by 61 percent. The increase for the first 3 quarters of 1971 expressed at an annual rate was 58 percent above 1970.

### Mortgage Interest Rates

Mortgage interest rates responded sharply to the general movements in market rates and to the reintermediation process. In March 1970, reduced deposit inflows and restrictive monetary policy had helped push secondary market yields on mortgages to a postwar peak of 9.29 percent from a 7.13-percent average in 1968. As market rates rose, the maximum rates permitted on FHA-insured and VA-guaranteed mortgages were raised from 6.75 percent in 1968 to 8.5 percent in January 1970. Subsequently, as open market rates declined and reintermediation occurred, the ceiling rate was reduced to 8 percent in December 1970, and down to 7 percent in February 1971.

In the early months of 1971 mortgage rates fell much more sharply than other long-term rates. The secondary market yield on FHA new-home mortgages fell 1.58 percentage points from December to April, reaching the year's low of 7.32 percent. Mortgage yields last spring were about equal to those paid on new long-term debt issues of the highest rated corporate borrowers. This drop in mortgage rates made an important contribution to the record demand for housing in 1971.

In early summer, mortgage rates began rising somewhat faster than other long-term rates as the housing expansion gained momentum. As the summer
wore on, discounts on insured mortgages rose to as much as 9 or 10 points to equate the 7-percent maximum permissible rate with the higher yields (7.97 percent as of early August) demanded by permanent mortgage investors. At the time, the ceiling rates on FHA and VA mortgages were not raised, in order to avoid adversely affecting inflationary sentiment. As an alternative to raising this mortgage rate ceiling, several Government agencies and Government-sponsored private institutions supported the market by mortgage purchases, thus reducing the number of discount points (lowering the yield) on these mortgages. Partly as a result of these actions, yields on insured mortgages began a downward trend in early August.

**Assistance to Mortgage Markets**

Because reintermediation in the first half of 1971 produced a large volume of private funds for investment in mortgages, the housing boom proceeded with little assistance from Federal programs. However, when the general rise in interest rates in the spring threatened the expansion in housing, Federal mortgage market assistance programs assumed much greater prominence. In June the Federal National Mortgage Association (FNMA), a privately owned Government-sponsored institution, sharply increased its purchases of insured mortgages. FNMA's net acquisitions of mortgages totaled $2.4 billion in 1971 as compared to $4.5 billion in 1970 and $3.8 billion in 1969. But the bulk of the 1971 purchases came after May, with approximately $1.4 billion of the year's purchases in Government-subsidized loans. The Federal Home Loan Mortgage Corporation also made purchases of $217 million of participations in conventional (uninsured) mortgages and $562 million of FHA-insured mortgages during 1971.

In the third quarter, the Federal Home Loan Bank System took several steps to aid the mortgage market. It liberalized terms on mortgage loans by allowing 95 percent conventional loans. In August, shortly after the NEP was announced, the FHLB Board reduced the liquidity requirements of member savings and loan associations from 7.5 percent to 7.0 percent to free more liquid assets for lending. Simultaneously, the Federal Home Loan Mortgage Corporation raised the price at which it purchased FHA-insured mortgages from 91 to 94 percent of par and reduced from 7% percent to 1% the yields it required on participations in conventional mortgages. These moves closely followed a new program, in which the Government National Mortgage Association (GNMA) used a $2 billion authorization to purchase unsubsidized FHA-insured and VA-guaranteed mortgages in cooperation with FNMA and other purchasers.

This plan subsidizes FHA and VA mortgage rates when rate ceilings produce high discounts. GNMA purchases these mortgages at 95 or 96 percent of par and sells them to any authorized purchaser at lower prices that reflect market interest rates. GNMA absorbs the difference between the support price and the market price, enabling home buyers to obtain mortgage financing at lower rates.
FISCAL POLICY TO AUGUST 15

The Administration's fiscal policy as reflected in the budget submitted in January 1971 was in general to keep expenditures from exceeding the revenues that would be yielded by the existing tax system under conditions of full employment. There were two reasons for the Administration's adoption of this principle. First, the conventional notion of balancing the actual budget more or less all the time had proved to be unworkable because either tax increases or expenditure cuts would be required whenever revenue was depressed by an economic slowdown, and this would be precisely the wrong time for a restrictive fiscal policy. In fact, this standard of fiscal policy had not been followed by an Administration for almost 40 years. Second, some rule of policy that would confine expenditures within the limits of what the Government was willing to raise in taxes was necessary to enforce economy in Government. The principle that expenditures should not exceed full-employment revenues has the advantage that fiscal action likely to intensify the slowdown would be avoided while the discipline of the basic relationship between revenues and expenditures would be retained.

In conformity with this principle, the Administration's January 1971 budget called for the following relationship between expenditures and the revenues that would be collected at full employment:

<table>
<thead>
<tr>
<th></th>
<th>Outlays</th>
<th>Revenues at full employment</th>
<th>Excess of revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fiscal 1971</td>
<td>212.8</td>
<td>214.2</td>
<td>1.4</td>
</tr>
<tr>
<td>Fiscal 1972</td>
<td>229.2</td>
<td>229.3</td>
<td>0.1</td>
</tr>
</tbody>
</table>

The outcome for fiscal 1971 was close to these plans. Estimated full-employment revenues after the end of the fiscal year were only $0.1 billion below the January 1 estimates. Outlays were $1.4 billion, or about one-half of 1 percent, under the estimate. Instead of an excess of full-employment revenues of $1.4 billion there was an excess of $2.7 billion as then defined (see footnote, p. 65).

Developments in the first 6 months of 1971 more significantly changed the estimates of the full-employment budget for fiscal 1972. On the revenue side the postponement, from 1971 to 1972, of the increase in the base for Social Security contributions reduced estimated fiscal 1972 receipts by $2.6 billion. This was expected to be offset in part by an increase in the Social Security contribution rate to take effect January 1, 1972. The net effect of these and other smaller changes was to reduce the estimated full-employment receipts by $1.9 billion. Estimated expenditures were raised by $4.7 billion. The largest item in this total was an increase of $1.4 billion of Social Security benefits above the budget. Other major items were an increase of $1 billion in the estimated payments for unemployment compensation because of the continued high rate of unemployment, and a pos-
sible increase of $0.8 billion in military pay as a result of congressional action.

Thus there was in prospect an excess of expenditures over full-employment revenues of $6.5 billion in fiscal 1972, compared to an excess of revenues of $2.7 billion in fiscal 1971.* On the national income accounts basis the surplus would show a decline of about $3.5 billion between the 2 fiscal years.

This estimate for fiscal 1972 as it appeared in July depended heavily on action still to be taken by Congress. Although the estimate made some allowance for probable delays in the enactment of expenditure programs that had been proposed by the Administration, even longer delays were possible. And although the estimate also made some allowance for pending congressional proposals above the budget, not all of those possibilities were expected to materialize. Despite these uncertainties, it seemed highly probable in the summer of 1971 that there would be a significant shift from a full-employment surplus in fiscal 1971 to a full-employment deficit in fiscal 1972.

The Administration considered this development appropriate in view of the sluggishness of the economy. At the same time the Administration was averse to making decisions that would add substantially to expenditure commitments for the future. Even within the limits of fiscal 1972, while more fiscal stimulus was desired, there was danger of excessive expansion in the prevailing inflationary atmosphere.

THE NEW ECONOMIC POLICY

WHERE WE STOOD ON AUGUST 15

As the summer of 1971 progressed, these facts became increasingly clear:

1. The economy was rising, and a continued rise could be expected; but the rise was not as fast as was desirable, especially from the standpoint of reducing unemployment.

2. Although the rate of inflation had stopped rising and might have declined, the decline was not clear cut, and there was some danger that the rate might rise again.

3. The U.S. international balance-of-payments position was deteriorating sharply, and willingness abroad to hold dollars was ebbing.

While these facts were clear, their reasons and their implications were unclear. The rate of economic expansion in the first half of the year was not less than many forecasters had predicted, but two aspects of the limited expansion were puzzling. As noted earlier, the rate of expansion of the money supply had been extraordinarily large, much larger than had been commonly

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*In this calculation, expenditures for unemployment compensation payments are not standardized for the unemployment rate that would prevail at full employment. It should be noted, however, that the estimates for fiscal 1972 made in July 1971 assumed about the same average rate of unemployment for the fiscal year as was actually experienced in fiscal 1971. This procedure has been changed for the fiscal 1973 budget, which standardizes for the unemployment rate.
expected at the beginning of the year. Even when allowance was made for some lag between the increase in the stock of money and any consequent increase in economic activity, the response of the economy to the monetary expansion was less than many studies had found in previous experience.

One possible explanation was that recollection of the liquidity squeeze of 1970 left individuals and businesses with an extraordinary desire to rebuild their money balances when interest rates declined, as happened in early 1971. This attitude might have been reinforced by the belief that rapid monetary expansion presaged a future rise in interest rates. In any case the rapid growth of money in the first half of 1971 seemed to have resulted from a rapid growth in the demand for money and did not imply a growth of money relative to desired cash balances, which in time would have stimulated more economic expansion.

The other unusual feature of the limited expansion was the exceptionally high saving rate of 1971. Personal saving for the first 3 quarters of the year represented 8.3 percent of disposable personal income, as compared to an average of 6.3 percent in the preceding 10 years. The high rates of unemployment and inflation in 1970 and 1971 may have contributed to the high saving rate, as households tried to protect themselves against those hazards. Whether there was another independent factor, “lack of confidence,” as commonly claimed is difficult to say. The measurements we have of this factor are weak and their historical connection with savings is loose. Even in retrospect, the reasons for the exceptionally high saving rate of 1971 are not entirely known.

Why the slowdown in the inflation was so halting and uncertain is another question which has not been clearly answered. Although this phenomenon is often ascribed to “structural” changes in the economy, these structural changes are not unmistakably evident. And although the delay in the disinflationary process was undoubtedly connected with the strength and duration of the inflation in the preceding years, one could not be sure that this explanation alone was sufficient.

The third part of the picture, the great enlargement in 1971 of the balance-of-payments deficit, also had its share of unanswered questions. On the basis of past experience, the sharp swing in the trade deficit was somewhat more than one might have expected from the rise in domestic demand and the slower expansion of foreign economies. Nor was it clear why the trade balance turned to deficit at a time when the rate of inflation in the United States was less than in most other industrial countries.

Policy in the summer of 1971 had to address the uncertainties as well as the obvious facts of these three interlocking problems. The relations among the problems greatly complicated the choice that had to be made.

The Administration's economic targets and projections at the beginning of the year were predicated on the idea that if the economy failed to rise at the desired rate, steps could be taken to make it rise more rapidly. This
option was open in the middle of 1971. In fact, the planned fiscal policy for fiscal 1972 had already been made more expansive than had been contemplated in the January budget, and further moves in this direction were possible. Also, the rate of increase of the money supply had been larger than had been expected at the beginning of the year, and actions already taken by the Federal Reserve to slow this expansion could have been modified or reversed.

However, consideration of these expansive moves in the summer of 1971 ran first into the fact that the rate of inflation was still high, and then into the danger that it might rise again. It could have been argued that a more rapid rate of economic expansion would help to slow down the inflation because it would speed up the growth of productivity and cut the rise in unit labor costs. Although this argument was quite plausible early in 1971, a half year later it seemed less convincing in the existing psychological atmosphere, where any action that looked inflationary tended to increase the expectations of inflation, even though the indication was superficial. In fact, some were concerned at the time that action intended to be expansive might really be restrictive because the expansive measures might intensify fears of inflation, raise interest rates, weaken confidence, and thereby depress consumer and business spending. Moreover, there was a related danger that fiscal and monetary expansion might make America's international financial problem more difficult by increasing the supply of funds available for investment abroad and by arousing fears that American inflation would speed up again.

At the same time, the continued high rate of unemployment ruled out the restrictive approach to the problems of the rate of inflation and the balance of payments. Moreover, the Administration was determined not to try to solve the balance-of-payments problems solely by tightening up controls on international transactions. This had been tried repeatedly in the preceding decade without yielding a satisfactory long-term solution.

THE AUGUST 15 DECISIONS

The key to unraveling this knot of difficulties was the necessity for dealing with the international financial problem promptly and the Administration's determination to deal with it in a bold and lasting way. The decision initiated two policy actions in the international economy. First, the United States suspended the convertibility of dollars into gold or other international reserve assets, in order to protect the U.S. reserve position from further drain and to signal to other countries our determination to achieve meaningful improvement in our own position as well as needed reform of the international trade and payments system. Second, the United States imposed a temporary surcharge on imports, generally at the rate of 10 percent, to help protect the U.S. payments position until other more satisfactory actions could be taken that would assure a stronger balance-of-payments position for this country.
These international decisions tipped the scales on an issue that had been the subject of intense consideration in the Administration for many months, and indeed since January 1969. This was the question whether the Administration should intervene directly in holding down wages and prices—adopting what had come to be called an “incomes policy”—and, if so, on what scale and in what way.

There were two fundamental objections to adopting such a policy:

1. Experience with such policy as it had been practiced abroad suggested that it would not work—or at least not with much effect or very long—for the natural reason that success would require that powerful groups suspend the effort to reap the full advantage of their power.

2. Such a policy, at least if continued for very long, would interfere with the efficiency of the economic system and might create an undesirable increase in the power of the government over its citizens.

On the other hand, a number of considerations argued for some direct intervention:

1. Progress against inflation was disappointingly slow, and despite the unspectacular record of incomes policies elsewhere the possibility of some assistance from that source, even if temporary, could not be ruled out or discounted.

2. There seemed to be a large and growing sentiment in the country for some kind of incomes policy, and steps in that direction might relieve anxiety, strengthen confidence, and improve the economy. This sentiment also increased the chance of getting the kind of voluntary self-restraint required for success.

3. The Administration’s acute consciousness of the pitfalls encountered in previous attempts might enable it to avoid, on the one hand, premature collapse of the control system and, on the other hand, its unnecessary prolongation.

The Administration took limited steps to influence wage and price behavior directly in 1969 and 1970. These included actions with respect to lumber, and the construction industry generally, as well as the institution of the National Commission on Productivity, the Regulation and Purchasing Review Board, and the Inflation Alerts, as described in the 1971 Economic Report of the President. Early in 1971 the Administration took a much stronger step, establishing a system of wage controls in the construction industry, with parallel actions intended to affect other cost elements in the industry (see Chapter 2, where the construction program is described). This action was the first use of the mandatory control power given to the President by the Congress through the Economic Stabilization Act of 1970.

The steps decided upon for dealing with the international situation introduced a potent new argument into the Administration’s consideration of the merits of a comprehensive system of controls. Improvement of our international position would require effective and convincing action on domestic inflation, in addition to the action the United States was seeking.
in the international sphere. Such action on the domestic front would assure our trading partners of our intentions and provide the framework for a cooperative approach to the solution of international payments problems.

These considerations, combined with others already present, led to the decision to institute a powerful, but temporary, price-wage control system. Once this decision had been made it altered the balance of considerations with respect to a more expansive fiscal policy. Action to make fiscal policy more expansive had been limited by the need to avoid intensifying any inflationary expectations and stepping-up the inflation. The establishment of the direct wage-price controls created room for some more expansive measures, because it provided a certain degree of protection against both the fact and the expectation of inflation. This situation had to be approached with caution, because excessive expansion could make the price-wage control system unworkable. Still there could be no doubt that the tolerable rate of expansion had been increased.

Thus, the decisions of August 15 consisted of a three-part, integrated package: (a) International measures aimed at the balance of payments; (b) controls aimed at checking inflation; and (c) fiscal measures aimed, in combination with the international measures and controls, at speeding up economic expansion and reducing unemployment.

The international measures taken on August 15 and their sequels are described in Chapter 5. The controls are discussed in Chapter 2. Here we take up the fiscal measures and the expected effect of the total program.

**FISCAL ELEMENTS IN THE NEW ECONOMIC POLICY**

The fiscal package proposed by the Administration on August 15 (as described in detail by the Secretary of the Treasury to the House Ways and Means Committee on September 8, 1971) was primarily motivated by the desire to stimulate at once a more rapid expansion of the economy. The composition of the package reflected a number of other objectives: To improve the balance of trade, to accelerate productivity growth by raising investment, to minimize the loss of long-term revenue-raising capacity, and to hold down the deficit in the budget for fiscal 1972, while recognizing realistically the likely outcome for the budget.

The package included the following items whose effects on the 1972 budget are shown in the table:

1. **A job development credit.** This would provide businesses with a tax credit of 10 percent for new investment in the first year of the program and 5 percent for investment thereafter. The two-tier form of credit would create a strong incentive to push investment forward into the first year of the program and would also hold down the revenue loss in subsequent years.

2. **Repeal of the 7-percent excise tax on automobiles.** This change was expected to have a stronger immediate effect on spending, production, and employment than a reduction in, say, the corporate or individual income
tax with an equivalent revenue loss. Repeal of the tax would also reduce the price level a little.

3. **Two steps changing the timing of tax cuts that had been previously legislated.** One change would raise the individual exemption to $750 on January 1, 1972, instead of to $700 on that date and $750 on January 1, 1973. The other would increase the standard deduction on January 1, 1972, to 15 percent with a $2,000 maximum. Both of these moves would increase the after-tax incomes of individuals, and both were expected to increase consumer spending in 1972 without reducing the revenues after 1973.

4. **A temporary surcharge on dutiable imports, generally at the rate of 10 percent.** (When all exceptions to the 10-percent rule were taken into account, the effective rate of surcharge came down to 4.8 percent.) The surcharge was not imposed to raise revenue but to provide the U.S. external position with some temporary protection. The surcharge would raise revenues; but unlike the conventional revenue-increasing measure it would stimulate rather than restrain the economy.

5. **Provision for the Domestic International Sales Corporation (DISC).** Through this new type of organization, U.S. exporters would be able to obtain a deferral of income tax on their earnings from qualified export sales. The purpose was to eliminate the previous bias that had worked against exporting and in favor of manufacturing abroad, and thus to stimulate exports.

6. **Recognition that certain proposed expenditure programs had been delayed in the legislative process and thus required a reduction of estimated fiscal 1972 outlays.** The main items involved were general and special revenue sharing and welfare reform.

7. **Deferral for 6 months of the Federal pay increase scheduled to take effect on January 1, 1972.** This was the Federal counterpart of the wage freeze being put into effect on August 15.

8. **A 5-percent reduction in Federal employment.** Such a reduction would be the most effective way to reduce Federal outlays with minimum short-range loss of service to the citizens.

9. **Miscellaneous small reductions in expenditures.** These included a 10-percent cut in foreign aid.

As Table 19 shows, the effect of this package was to reduce estimated expenditures for fiscal 1972 by about $1.1 billion more than the reduction in estimated receipts. At the same time, the program was intended and expected to be expansionary. The primary reason, as already noted, was that the surcharge, while revenue-yielding, was foreseen as having an expansive effect on domestic production, and the two-tier investment credit as exerting an unusually powerful effect on investment in the next year relative to the revenue loss in that year.

In addition, a common view was that both business spending and consumer spending had been held down in the early part of the year by anxiety over the inflation. One motive for the freeze on prices, wages, and rents, was the
TABLE 19.—Effect on fiscal year 1972 Budget of tax and expenditure changes in New Economic Policy

<table>
<thead>
<tr>
<th>Type of change</th>
<th>Billions of dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue reductions</td>
<td></td>
</tr>
<tr>
<td>Job development credit</td>
<td>5.8</td>
</tr>
<tr>
<td>Accelerated increase of personal exemptions</td>
<td>2.7</td>
</tr>
<tr>
<td>Elimination of auto excises</td>
<td>1.9</td>
</tr>
<tr>
<td>Elimination of auto excises</td>
<td>2.2</td>
</tr>
<tr>
<td>Revenue increase</td>
<td>2.0</td>
</tr>
<tr>
<td>Import surcharge *</td>
<td>2.0</td>
</tr>
<tr>
<td>Revenue reductions, net</td>
<td>3.8</td>
</tr>
<tr>
<td>Expenditure reductions</td>
<td></td>
</tr>
<tr>
<td>Freeze of Federal pay increase</td>
<td>4.9</td>
</tr>
<tr>
<td>Deferral of general revenue sharing</td>
<td>1.3</td>
</tr>
<tr>
<td>Reduction of Federal employment</td>
<td>1.1</td>
</tr>
<tr>
<td>Deferrals of some special revenue sharing</td>
<td>.8</td>
</tr>
<tr>
<td>Deferral of welfare reform</td>
<td>.5</td>
</tr>
<tr>
<td>Other</td>
<td>.6</td>
</tr>
<tr>
<td>Excess of expenditure reductions over net revenue reductions</td>
<td>1.1</td>
</tr>
</tbody>
</table>

1 It was arbitrarily assumed that the surcharge would continue until June 30, 1972.

Source: Treasury Department.

hope of relieving this anxiety and encouraging more spending. If these ends were accomplished there could be a major expansive effect without any prior change in the budget.

Many aspects of the full package—that is, the freeze, the international measures, and the fiscal steps—were unprecedented, and therefore any reliable calculation of the size of their effects was exceedingly difficult. The Council of Economic Advisers estimated at the end of August that the Administration's package would make real 1972 GNP in 1972 prices about $15 billion greater than it would have been without the new program, but this figure was recognized as subject to a wide range of uncertainty.

The legislative outcome followed the general outline of the Administration's proposal but differed in several respects. Congress did not enact the 10-percent–5-percent job development credit, but instead passed a permanent 7-percent credit. Congress disapproved the revision in the treatment of first-year depreciation which the Treasury had made administratively. Congress also cut back the Administration’s proposal, which had already been passed by the House in 1970, to defer taxes on profits from exports. On the other hand, Congress not only raised the personal exemption to $750 for calendar year 1972 but also raised the 1971 exemption to $675. Congress went beyond the Administration's proposals in several other respects: It raised the “low income allowance,” or minimum standard deduction, to $1,300 from $1,000 for 1972 and repealed the 10-percent excise tax on light trucks. Other legislation made the Federal pay increase effective on January 1, 1972, contrary to the Administration’s proposal. A new deduction for child care and household help was also introduced.
The effect of the congressional action was to reduce the net revenue loss for calendar 1972 about $1.2 billion below the cost of the Administration's proposal. Possibly more significant was the failure to adopt the job development credit in its original form, which provided a strong incentive for investment in 1972. Nevertheless, the enactment of the tax bill contributed to the expectation that a strong economic advance lay ahead, an expectation which was becoming general as 1971 ended.
CHAPTER 2

Inflation Control Under the Economic Stabilization Act

Public Law 92–210, the Economic Stabilization Act Amendments of 1971, requires that the Economic Report of the President include a section "describing the actions taken under this title during the preceding year and giving an assessment of the progress attained in achieving the purposes of this title." This chapter is intended to fulfill that requirement. There is, however, no intent to represent the description of the control regulations contained herein as legally binding interpretations.

At the beginning of 1971, the Administration and the President were hopeful that reliance on appropriate monetary and fiscal policies, along with the competitive forces of the free market, would be sufficient to curb inflation. At the same time, there was recognition that the course of events during 1971 would critically affect the choice of instruments to achieve the desired goals.

The Government's instruments for inflation control include a range of policies which are appropriate to various phases and types of inflation. One of these instruments is the authority to impose direct controls as provided under the Economic Stabilization Act of 1970, as amended. It became necessary to employ this authority in 1971, at first to restrain excessive wage and price increases in the construction industry, and subsequently to initiate overall restraints on wages, prices, and rents in the face of an exceptionally stubborn inflation.

In his Economic Report of February 1, 1971, the President noted situations where the Government had taken action to reinforce market resistance to inflationary pressures. Included were these actions:

—Measures to augment the supply of lumber and thus counteract excessive price increases.
—Steps to increase oil production on Federal offshore leases and to expand oil imports in order to restrain crude oil price increases.
—A review of the steel industry's economic problems with special refer-
ence to inflationary price increases in early 1971 on some steel products. (After the Administration had publicly expressed its disapproval, these increases were reduced by about one-third.)

The President's Report also emphasized his particular concern about excessive increases in wages, costs, and prices in the construction industry, especially in view of the high unemployment that existed among construction workers. He reiterated his December 1970 request that labor and management in the industry develop a plan to bring wages, costs, and prices into line with the requirements of national economic policy, saying that a workable plan would avert the need for Government action.

THE CONSTRUCTION PROGRAM

Concern with wage-price trends in construction was founded on the experience of the previous years. Construction workers had received abnormally large wage increases in the late 1960's. During 1970 the upward trend accelerated as nearly 700,000 union construction workers negotiated collective bargaining agreements which provided wage and benefit increases averaging 19.6 percent in the first contract year and 15.6 percent annually during the life of the contract. These increases were a major factor in the sharp rise in construction costs and prices, and they may have served as a spur to inflationary wage demands by both union and nonunion workers in other sectors of the economy.

The appeal for a voluntary program of cost restraint was not successful. Late in February 1971 the President suspended the Davis-Bacon Act, which sets wage standards for federally funded, assisted, or insured construction. By late March, the Administration, working with labor and industry leaders, had developed a cooperative program designed to restrain cost increases. On March 29 the President reinstated the Davis-Bacon Act and by Executive Order 11588 formalized the cost restraint program. Under the authority provided by the Economic Stabilization Act of 1970, this Executive Order established the administrative rules, organizations, and procedures to be used in the stabilization of wages and prices in the construction industry. The administrative mechanism for restraining wage increases took the form of a 12-member tripartite Construction Industry Stabilization Committee (CISC). With the aid of Craft Dispute Boards made up of labor and management representatives for individual construction trades, the CISC was to review and pass upon the acceptability of all economic adjustments in all collective bargaining agreements negotiated in the construction industry.

Executive Order 11588 spelled out two basic criteria for evaluating proposed increases in compensation. They were: (a) "Acceptable economic adjustments in labor contracts negotiated on or after the date of this Order will be those normally considered supportable by productivity improvement and cost-of-living trends, but not in excess of the average of median increases in wages and benefits over the life of the contract negotiated in major con-
struction settlements in the period 1961–1968”; and (b) “Equity adjust-
ments in labor contracts . . . may, where carefully identified, be considered
over the life of the contract to restore traditional relationships among crafts
in a single locality and within the same craft in surrounding localities.”

Because of the large number of contracts to be reviewed by the CISC, the
time needed to install administrative procedures, and the return of some
proposed contracts to Craft Dispute Boards for renegotiation, a backlog of
unapproved cases quickly developed. Its existence caused problems when
the wage-price freeze was instituted on August 15. The freeze applied to
construction, as to all other industries, but it was not retroactive. Because
the construction contracts in the backlog had been decided prior to
August 15, the Cost of Living Council had no jurisdiction; the contracts
could, with CISC approval, go into effect as agreed. Thus the CISC con-
tinued to operate during the freeze and, subsequently, in Phase II under
the jurisdiction of the Pay Board, to clear up the backlog of old cases; this
process continued until late December.

In all, the CISC reviewed over 1,500 new collective bargaining agreements
that had been settled by the parties. Over one-fifth of these were not ap-
proved in their initial form by CISC. Construction industry collective
bargaining agreements settled and approved in the second and third quarters
of 1971 provided first-year wage and benefit increases of about 11 percent, a
significant reduction from 1970, when such increases averaged 19 percent.
CISC thus retarded the rate of growth in the compensation of unionized
construction workers and its existence appears to have been an important
factor in a reduction of strike activity in the industry. How much greater the
effect of the construction industry program would have been if the general
wage-price control system had not been established will never be known,
but real progress was undoubtedly made during the period of its independ-
ent existence.

Executive Order 11588 also established an Inter-Agency Committee in
the Federal Government to develop criteria for establishing acceptable pric-
ing policies for construction contracts and acceptable compensation changes
for management and staff employees in the industry. The Inter-Agency Com-
mittee had developed and published draft regulations and was in the process
of drafting final regulations when its activities were superseded by the
broader price and compensation controls of the New Economic Policy.

AUGUST 15: THE WAGE-PRICE FREEZE

Acting under authority of the Economic Stabilization Act of 1970, the
President announced on August 15 an immediate 90-day freeze on prices,
rents, wages, and salaries and creation of a Cabinet-level Cost of Living
Council (CLC) to administer the freeze and to advise on further stabiliza-
tion policies and actions.

The combination of conditions that led to direct Government action to
restrain prices and wages was discussed earlier. These conditions did not
automatically determine the type, duration, or rigor of the policy initially undertaken, which could, of course, have ranged from a noncompulsory type of policy operating mainly through moral suasion to the comprehensive mandatory freeze that was actually applied.

During the first half of 1971 the Administration was under increasing pressure to adopt some form of incomes policy, preferably a noncompulsory one. However, such a policy was not considered appropriate for two reasons. First, there was reason to believe that public opinion would regard such a "soft" control policy as merely the first in a series of moves toward compulsory controls. The result would be widespread efforts to increase prices and wages in anticipation of a more stringent program; the Government's likely reaction—successive escalations of controls—would result in more inequities, distortions and, ultimately, administrative difficulties than would a comprehensive freeze. Although the situations were considerably different, experience with controls in the initial stages of the Korean conflict suggested that this would be the likely pattern of response to voluntary guidelines.

Second, the nearest American approach to a policy of persuasion, the guidelines of the previous Administrations, had been abandoned in 1966. The Administration believed in 1971 that exhortation had lost most of its force.

Beyond an incomes policy supported only by exhortation, there were, of course, many possible variations of compulsory controls. The Phase II controls that followed the freeze represent one of those variations. Common to all such systems, including the Phase II apparatus, is a need for time to formulate the program, to set up the administrative organization, and to write and disseminate regulations. Such preliminary processes instantly become public knowledge, with the predictable result that during the startup phase of a complex restraint program all elements of the economy attempt to improve their relative position before the controls become effective; the net effect is to make the inflationary spiral even steeper.

The chief virtues of the freeze were its decisiveness, comprehensiveness, and administrative simplicity. The President's announcement that practically all wage and price increases were prohibited left no doubt of a drastic change in the upward trend of prices and wages. Equally important, a freeze could be—and was—imposed immediately, precluding anticipatory price and wage increases and providing time to prepare and set in motion more lasting and flexible measures.

The Administrative System

The Cost of Living Council (CLC) consisted of the Secretaries of the Treasury (Chairman of the CLC), Agriculture, Commerce, Labor, Housing and Urban Development, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers (Vice-
Chairman of the CLC), the Director of the Office of Emergency Preparedness and the Special Assistant to the President for Consumer Affairs. The Chairman of the Board of Governors of the Federal Reserve System was named adviser to the CLC. A small staff headed by a full-time executive director supplied services including policy review, planning and analysis, public information, legal counsel, and administrative services.

The CLC, under the authority delegated by the President in Executive Order 11615, issued a series of orders putting the general freeze into operation and made the principal policy decisions during the freeze. Policy was implemented through an organizational system headed by the Director of the Office of Emergency Preparedness (OEP) which was delegated the authority to administer, monitor, and enforce the freeze. The OEP, through its nationwide organization (which is designed to meet national emergencies or natural disasters and plan for economic contingencies arising from possible emergencies) successfully carried out this assignment during the freeze period. The OEP was assisted in interpreting and enforcing the freeze regulations by the Treasury Department's Internal Revenue Service, a specially designated unit of Department of Justice attorneys, and Agricultural Stabilization and Conservation Service field offices.

**Freeze Policies**

Reflecting the basic objectives of the freeze, the CLC's policy decisions tended in the direction of the most emphatic possible stop to the inflation. Only a minimum of exceptions to the freeze on prices, wages, and rents was permitted. Because of the complexities of the markets for many goods and services, however, it proved difficult to develop precise definitions that applied with equal effect in all situations. The basic principle of the freeze, as applied to wages, prices, and rents, was that the rate of payment during the freeze period—August 16 to November 13—could not exceed the rate in effect during the base period—July 16 through August 14.

**Wages and Salaries.** The crucial question in applying the basic principle of the freeze was what “in effect” meant in cases where a prefreeze contract or other arrangement called for a larger wage payment during the freeze period than had actually been paid during the base period. It was argued at the time that contracts have a sanctity which must be respected and that a logical line could be drawn to distinguish contracts from other arrangements incorporating the expectation of a wage increase. However, the opposing argument was that there was neither a logical nor an equitable distinction in this type of situation, and to give preferential treatment to contracts as the bases for granting wage increases would discriminate against workers not covered by contracts.

This issue was resolved by deciding that wages would be limited during the freeze to the rates actually paid workers during the base period, even though they might have entered into an agreement calling for higher rates to take effect sometime during the freeze. Such resolution of the issue
was deemed to be the most explicit and straightforward application of the freeze. Moreover, approval of these higher rates would have seriously undermined effectiveness of the freeze and probably would have eroded public support, which was based on equal treatment of all groups. Another important concern in this decision was the desire to avoid negative effects on production or investment. To allow wage increases to go into effect during the freeze, while keeping an immovable lid on prices, would have squeezed profits severely in some cases and might have resulted in some firms’ temporarily curtailing production and employment, especially since relief might have been expected after the freeze. To identify such cases and permit selective price increases only where they were necessary to prevent this result was not administratively feasible in the time limits of the freeze period.

**Prices and Rents.** The decision not to permit wage increases to take effect during the freeze even if they had been contracted for earlier was paralleled in the CLC regulations for both prices and rents. Rent increases were not allowed, even though tenants before August 15 had signed leases, secured by deposits, calling for increases.

In the case of prices, the ceiling for the freeze period was the highest price at or above which a “substantial volume” (interpreted to mean at least 10 percent of the total) of transactions had taken place in the 30 days preceding the freeze. If no transactions had taken place during that period, the nearest preceding 30-day period in which transactions occurred was to be used as the base. A price transaction was deemed to have occurred when the seller shipped a product to the buyer, not when the order for the product was received. Thus, sales contracts entered into before August 15 providing for deliveries during the freeze at higher than base period prices were set aside.

In keeping with the principle of the freeze, price increases were not sanctioned on the basis of cost increases; inequities and hardships arising from this rule were assumed to be endurable for the 90-day duration of the freeze. Raw agricultural products were exempted in the Executive Order, however, and certain limited exceptions—for example, import price increases and seasonal price adjustments—were allowed.

**Raw Products.** The exemption of raw agricultural products, including seafood products, from price control created problems for some processors who found their operating margins squeezed between uncontrolled costs and frozen selling prices of the processed foods. Nevertheless, increases in the uncontrolled prices were not allowed to be passed through, although there were some minor extensions of the definition of “raw” products.

**Imports.** Imported products were subject to price increases during the freeze at the level of the importer from three sources:

1. The surcharge on dutiable imports (generally 10 percent of the customs valuation). No surcharge was applied to duty-free imports or those under quota.
2. An increase in dollar price resulting from fluctuations in international exchange rates.

3. Price increases in world markets which were reflected in the delivered price in the United States.

On the principle that U.S. Government actions were directly responsible for the surcharge, the CLC permitted the dollars-and-cents amount of the surcharge on a particular imported product to be passed through successive transactions, including processing, to the final purchaser. Increases due to dollar depreciation or price changes on world markets were allowed to be passed on as long as the imported good retained its original form. If an import was physically transformed, the price increase had to be absorbed.

Seasonal Price Adjustments. Sellers of goods and services which were characterized by a marked seasonal fluctuation in price were likely to be unfairly penalized by ceiling prices based on the immediate prefreeze period. Therefore, the CLC ruled that prices showing a "large distinct fluctuation at a specific, identifiable point" in each of the past 3 years would be allowed to increase to the level reached during the same seasonal period of the preceding year.

New Products. As in past periods of price control, the definition of a product became controversial. The CLC decided that to be considered new a product or service must be "substantially different" and not merely changed in fashion, style, form, or packaging. In the event of introduction of a genuinely new product or service during the freeze, two alternative methods of pricing were permitted; the price could be based on the price of comparable products or services or on the unit cost plus the normal markup of similar products or services.

Other Rulings. The CLC determined that price ceilings did not apply to exports and that increases in various welfare payments, workmen's compensation, and employers' contributions to previously effective fringe benefits were not covered by the freeze. Pay increases resulting from bona fide promotions to jobs of greater responsibility and progression of apprentices or learners to more skilled levels according to preestablished programs were permitted on the grounds that they were not increases in the wage for a given job. Actual wage increases were also permitted to meet requirements of minimum wage laws or to eliminate illegal discriminatory employment practices.

Exemptions. In all, nearly 6,000 requests for exemptions and exceptions to the freeze regulations were considered by the CLC; five individual exemptions were made. Many requests were from persons in financial difficulties not due to the freeze. Many others were from persons whose proposed changes were permissible under existing regulations.

The freeze generated numerous problems for its administrators, but most of their concern was occasioned by a small proportion of the economy's millions of different wages, prices, and rents. The public was kept informed by a series of questions and answers that amplified and interpreted the
definitions of the original Executive Order released by the CLC; the substance of these interpretations and definitions was incorporated in the more extensive regulations and circulars published in the _Federal Register_ by the Office of Emergency Preparedness.

**Dividends and Interest.** The Economic Stabilization Act of 1970 did not include provisions for regulating interest or dividends. Control of dividend payments during the freeze period was carried on through a program of voluntary compliance. The Secretary of Commerce sent telegrams to about 1,300 large corporations, asking them voluntarily to forego increases in dividends during the freeze, and he received practically unanimous support. Although interest rates were not controlled during the freeze, most rates dropped significantly, in part because of the abatement of inflationary expectations.

**Administrative Record of the Freeze**

Little administrative planning and no organizational preparation could be carried out before August 15. Such activity might have given public notice to the impending control program and jeopardized its prospects for success. As a result, the freeze was as much a surprise to almost all of the people who were to help administer it as it was to the Nation at large. Given these circumstances at its initiation, the administration of the freeze program must be accounted outstandingly effective.

In exercising its authority to administer, monitor, and enforce the freeze regulations, OEP had the benefit of its established facilities, including a system of 10 regional offices (two of which were specially opened during the freeze) connected to Washington headquarters by private teletype. In addition to OEP's 300 employees, personnel from many other Government departments and agencies, including 2,500 IRS employees, were engaged at least part time in the program.

**Inquiries and Complaints.** During the freeze period approximately 1 million inquiries regarding the stabilization program were received (mostly by telephone); of these two-fifths concerned prices and the rest were equally divided between wages and rents. Most of these were requests for interpretations, but nearly 50,000 were complaints of alleged violations, 75 percent of which concerned prices. Rents accounted for 19 percent of the complaints and wages 6 percent. Over 60 percent of these complaints were found not to involve actual violations; almost all of the remaining cases were brought into compliance informally or through routine investigation.

In addition, over 85,000 spot checks carried out by IRS indicated over 90 percent in compliance. Of those in violation, over half promptly and voluntarily complied when the violation was pointed out.

**Litigation.** About 200 cases of violators who refused to comply voluntarily after initial contact were forwarded to OEP regional offices during the freeze; all but a few of these cases were resolved without court action. Eight cases had reached court and 23 more were in various stages of prepara-
tion in the Justice Department as the freeze ended. This relatively small volume of litigation reflects the widespread compliance with the freeze.

**Effectiveness of the Freeze**

Viewed as a whole and against the circumstances of its initiation, the freeze was a major success. Its primary purpose was, of course, to reduce the rate of inflation and its success in that respect may, in some degree, be inferred from the behavior of the major price indexes.

**Consumer Price Index.** During the freeze the rate of increase of consumer prices as measured in the consumer price index slowed by more than half from the prefreeze rate (Table 20). The index did not show a com-

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**Table 20.—Changes in consumer prices, selected months, 1971**

<table>
<thead>
<tr>
<th>Item</th>
<th>Percentage change from 3 months earlier (annual rate)</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>February</td>
</tr>
<tr>
<td>All Items</td>
<td></td>
</tr>
<tr>
<td></td>
<td>4.0</td>
</tr>
<tr>
<td>Food</td>
<td>1.7</td>
</tr>
<tr>
<td>Nonfood commodities</td>
<td>3.2</td>
</tr>
<tr>
<td>Services</td>
<td>5.6</td>
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</tbody>
</table>

1 Not seasonally adjusted.

Source: Department of Labor.

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Table 21.—Changes in consumer prices, selected items, October to November 1971

<table>
<thead>
<tr>
<th>Group</th>
<th>Percentage distribution of October to November changes 1</th>
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</thead>
<tbody>
<tr>
<td></td>
<td>Total</td>
</tr>
<tr>
<td>Total 1</td>
<td>100.0</td>
</tr>
<tr>
<td>Food at home 2</td>
<td>100.0</td>
</tr>
<tr>
<td>Nonfood commodities</td>
<td>100.0</td>
</tr>
<tr>
<td>Services</td>
<td>100.0</td>
</tr>
</tbody>
</table>

1 Based on special analysis of 120,000 individual price comparisons.
2 Excludes raw agricultural products.

Source: Department of Labor.
for the September–October period. Some increases were, of course, permitted by the CLC regulations, but it was not possible to determine from these data whether the small proportion of increases that did occur were entirely the result of allowable increases.

**Industrial Wholesale Prices.** The effect of the freeze on wholesale prices, which is easier to observe because there are fewer lags in the collection of data, was even more impressive than in the case of the consumer price index. The index of industrial commodity prices, which had risen at an accelerating rate after the first 3 months of 1971, declined at an annual rate of 1.3 percent from August through November (Table 22). The decline affected most of the industrial commodity categories; the few increases that did occur were attributable to import price increases or factors such as the seasonal fluctuations associated with introductions of new automobile models.

**Average Hourly Earnings.** The freeze on the wage and salary side also was effective. Hourly earnings (adjusted to more nearly approximate wage rates) had shown an annual rate of increase of about 7 percent prior to August; this dropped to an annual rate of about 1¾ percent between August and November.

### PHASE II: ISSUES AND ORGANIZATION

The broad support of and compliance with the freeze reflected a national willingness to support a rigorous anti-inflationary program, even at the cost of some hardship. But it was clear from the outset that the freeze had certain important limitations if extended indefinitely. An indefinite freeze is unworkable in a dynamic economy, where technology, new products and changing demand patterns exert a continuing strong influence on prices. Movements of prices and wages serve the essential purposes of organizing and guiding the allocation of resources, and to suppress them for long

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**Table 22**—Changes in wholesale industrial commodity prices, selected months, 1971

<table>
<thead>
<tr>
<th>Commodity group</th>
<th>Percentage change from 3 months earlier (annual rate)</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>February</td>
</tr>
<tr>
<td>Industrial commodities</td>
<td>2.9</td>
</tr>
<tr>
<td>Textile products and apparel</td>
<td>-1.1</td>
</tr>
<tr>
<td>Hides, skins, leather, and related products</td>
<td>6.7</td>
</tr>
<tr>
<td>Fuels and related products and power</td>
<td>13.0</td>
</tr>
<tr>
<td>Chemicals and allied products</td>
<td>3.9</td>
</tr>
<tr>
<td>Rubber and plastic products</td>
<td>1.5</td>
</tr>
<tr>
<td>Lumber and wood products</td>
<td>9.0</td>
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<tr>
<td>Pulp, paper, and allied products</td>
<td>0.6</td>
</tr>
<tr>
<td>Metals and metal products</td>
<td>-4.7</td>
</tr>
<tr>
<td>Machinery and equipment</td>
<td>4.3</td>
</tr>
<tr>
<td>Furniture and household durables</td>
<td>3.7</td>
</tr>
<tr>
<td>Nonmetallic mineral products</td>
<td>11.6</td>
</tr>
<tr>
<td>Transportation equipment</td>
<td>4.5</td>
</tr>
<tr>
<td>Miscellaneous products</td>
<td>4.4</td>
</tr>
</tbody>
</table>

1 Not seasonally adjusted.

Source: Department of Labor.
would seriously distort resource allocation. The proper goal of the stabiliza-
tion program is to reestablish an acceptably low rate of price increase by
reducing expectations of continued strong inflation and eliminating, to the
extent possible, practices and behavior which sustain or promote inflation.
But underlying expectations of a continuing inflationary trend could not
be arrested by a short freeze. A sequel would therefore be required; this
plan was reported to the Nation in the President's October 7 announcement.

It was vital to the success of the effort to disinflate through a system of con-
trols that the transition from the freeze to Phase II should be orderly, well
understood, and widely supported. Many possible paths could have been
followed in the Phase II price-wage control system. In a free nation with a
market economy, however, these paths are somewhat circumscribed by social,
political, institutional, and economic constraints. In this instance, these con-
straints required that the control system employed in Phase II be as effective
and equitable as possible in reducing the inflation, while still permitting the
maximum operation of normal market mechanisms and ensuring an early
return to a free market economy. Administratively, the system also had to be
streamlined and efficient, and, to work, it had to earn a high degree of pub-
lic support. These considerations raised certain decisive issues. Paramount
among them were these questions:

Should the program be mandatory?
How comprehensive should the program be?
How should the program be administered and enforced?
Who should set standards of price-wage behavior?
What standards should be set?

In addressing these problems of Phase II, the President and his Cost of
Living Council consulted with numerous representatives of each major
interest in the control program: labor and business, farmers and consumers,
State and local governments, and the Congress. The discussions revealed
an almost unanimous belief that the anti-inflationary effort should be con-
tinued to a successful conclusion, but a great diversity of strongly held
opinion about the best strategy and procedures for achieving price stability.
A consensus was ultimately fashioned upon the belief that Phase II required:
(a) A clear-cut, publicly supportable goal for the disinflationary effort; (b)
machinery allowing the public and major elements of the economy to par-
ticipate in setting policy and administering the program; (c) an essen-
tially self-administered system embodying strong incentives to encourage
anti-inflationary behavior; (d) provision in the system for maximum con-
tinued operation of competitive pricing and free collective bargaining.

In the interests of equity and effectiveness (and for the reasons noted
earlier in this chapter with respect to the freeze) it was decided that Phase II
controls would be mandatory and initially as comprehensive in their direct
coverage as was administratively feasible. In large measure, this decision was
based on the intensity and pervasiveness of the prefreeze inflation. The intention was to preserve the psychological benefits already realized by the freeze, to prevent an outbreak of renewed inflationary increases in prices or wages in any uncontrolled sectors, and to establish a broad pattern of restraint and thus reassure the public that the process of stemming inflation would be as widely and evenly distributed as possible. This decision for almost universal coverage at the outset did not preclude the possibility of a subsequent relaxation of the controls by stages, as the effectiveness of the system was demonstrated, confidence in the control of inflation was strengthened, and sectors of the economy no longer requiring control were identified.

A major issue of post-freeze control strategy was which of two courses to pursue. One alternative was to follow up the freeze period with what might be called a semifreeze, holding close to the rigid standards of the freeze as long as possible. The danger here was that inequities and hardships caused by the freeze had built up so much pressure that there would be an explosion that might wreck Phase II before it got underway; also there would be increasing problems of resource allocation. The other alternative was to move quickly to the more flexible and durable standards that would eventually be needed, recognizing that this would cause a transitional bulge of wage and price increases. Because of concern that a rigid stance would both undermine the operation of normal market functions and force major confrontations that might endanger the continuation of the whole program, the second of the two courses was followed. The cost of this choice was a temporary period of wage and price increases in excess of the goal.

Maintenance of maximum cooperation and support was also a vital consideration in structuring the policy-setting bodies. On the wage side it was evident that participation of labor and management would be required to give both groups a voice in the direction of the program and to ensure equal treatment. It also was abundantly clear that administration and policymaking in this unique situation would require great expertise in the area of price-wage determination and that such ability was best found among persons with long experience and training in the field. Also, large segments of the Nation—including business, unions, and the general public—had increasingly supported a control program in 1970-71, and their insights and participation were believed to be an important factor in the successful operation of the controls program.

Structuring of the policy-setting bodies could have taken several directions but the considerations summarized above pointed toward a tripartite combination (equal representation of labor, management and the public) for policy determination in the wage area, and toward public membership only on the price-policy body. In matters of pay, the different types of expertise and, above all, the need and desire for cooperation dictated a tripartite board.
Announcement of Phase II

On October 7 the President announced the outlines of the Phase II program. The goal of the program, as proposed by the CLC, was to reduce the rate of inflation to the 2 to 3 percent range by the end of 1972, a reduction to about half the prefreeze rate. The development of guidelines and standards to attain this goal was to be in the hands of policy-setting units comprised primarily of personnel drawn from various sectors of the economy, outside of Government but acting in the public interest. The controls were to cover the economy broadly, were to be mandatory, and were to be removed when, in the President's judgment, conditions had been achieved which promised the maintenance of reasonable price stability without them.

In its specific provisions, the administrative machinery (established in Executive Order 11627) was to operate along participatory lines to the greatest extent practicable. The CLC, consisting of high Government officials and representing the President's direct interest, was assigned the responsibility of establishing broad goals, determining the coverage of the control program, overseeing enforcement, and coordinating the anti-inflationary effort in line with the overall goals (Chart 9).

The primary bodies created to develop standards and make decisions on changes in all prices (including rents) as well as compensation (wages, salaries, and fringe benefits) were, respectively, the Price Commission, composed of seven public members, and the tripartite Pay Board of 15 members, who were divided equally among business, labor, and public representatives.

Advisory committees were also established to promote a voluntary program to restrain interest rates and dividends, elicit State and local government cooperation, and to suggest means to curtail price increases in the health services industry. A rent advisory board including landlord, tenant and public representatives was created to counsel the Price Commission, while the preexisting tripartite Construction Industry Stabilization Committee was placed under the authority of the Pay Board. The National Commission on Productivity was expanded and assigned the advisory role of ensuring that the entire stabilization program encouraged productivity growth.

For purposes of administrative efficiency, the CLC decided that smaller economic units should not be required to give advance notice or to report price and wage increases which were consistent with the basic guidelines established by the Price Commission and Pay Board. The largest firms and employee groups were required to obtain advance approval from the Commission and the Board for any change, and an intermediate group was required to report after wages or prices were increased in accordance with the stabilization rules. These tiers are shown in Table 23. The CLC also recognized that prices of some products and services were either insignificant in the overall inflation problem, relative to the administrative difficulty of controlling them, or were subject to direct controls outside the Economic...
Chart 9

Post-Freeze Organization

- Committee on Interest and Dividends
- Committee on Health Services Industry
- Committee on State and Local Government Cooperation
- COST OF LIVING COUNCIL
  - National Commission on Productivity
  - PRICE COMMISSION
    - RENT ADVISORY BOARD
  - PAY BOARD
    - EXECUTIVE COMPENSATION SUBCOMMITTEE
      - Construction Industry Stabilization Committee
  - STABILIZATION OFFICES (INTERNAL REVENUE SERVICE)
  - Agriculture Stabilization and Conservation Service

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis
<table>
<thead>
<tr>
<th>Tier</th>
<th>Action required</th>
<th>Price increases (size of firm)</th>
<th>Wage increases (number of workers)</th>
</tr>
</thead>
<tbody>
<tr>
<td>I</td>
<td>(a) Prenotification of Price Commission or Pay Board (increase to be effective with approval of Commission or Board). &lt;br&gt; (b) Tier I firms to submit quarterly price, cost, and profits reports to Price Commission.</td>
<td>Sales of $100 million and over (1500 firms with 45 percent of all sales).</td>
<td>Affecting 5,000 or more workers (10 percent of all employees).</td>
</tr>
<tr>
<td>II</td>
<td>(a) Report to Price Commission or Pay Board. &lt;br&gt; (b) Tier II firms to submit quarterly price, cost, and profits report to Price Commission.</td>
<td>Sales of $50 million to $100 million (1,000 firms with 5 percent of all sales).</td>
<td>Affecting 1,000 to 5,000 workers (7 percent of all employees).</td>
</tr>
<tr>
<td>III</td>
<td>No reports (but increases to be made only in accordance with Price Commission and Pay Board regulations and to be subject to monitoring and spot checks).</td>
<td>Sales of less than $50 million (10 million enterprises with 50 percent of all sales).</td>
<td>Affecting less than 1,000 workers (83 percent of all employees).</td>
</tr>
</tbody>
</table>

Source: Cost of Living Council.

Stabilization Act. These were exempted from direct control. By year end this group included:

- Raw agricultural products
- Raw seafood products
- Life insurance
- United States Postal Service
- Certain custom products and services
- Exports
- Imports (first sale into U.S. commerce)
- International ocean shipping rates
- Damaged and used products
- Sales of U.S. Government property
- Real estate, both improved and unimproved (except for improvements completed after August 15, 1971, for a predetermined price)
- Rentals of residential units constructed (or substantially rehabilitated) after August 15, 1971
- Securities and financial instruments (including commodity futures on organized exchanges)
- State and local government fees and charges for services
- Tuition fees and charges of private nonprofit educational organizations
- Pay of Americans working and living abroad
- Federal pay, fees, and charges
- Wages below the Federal minimum
- Prices, rents, and wages in the Commonwealth of Puerto Rico
- Rents of farm, industrial, and nonresidential property.
Members of the Price Commission and Pay Board assumed their duties in late October. From then to mid-November, when the freeze ended, they had to organize staff, publish specific guideline regulations, and establish prenotification and reporting procedures. Both groups were also under immediate pressure at the opening of Phase II to deal with special problems created by the 90-day freeze.

**Price Standards**

In assuming its responsibilities, the Price Commission announced a goal of holding the rate of average price increases across the economy "to no more than 2½ percent per year." This conformed to the CLC's goal of getting the inflation down to no more than 2 to 3 percent by the end of 1972. The Price Commission also set forth the general rule that no price might be increased beyond the ceiling price established for the freeze period, except in accordance with its regulations. The terms of these regulations were as follows:

1. **Manufacturers and Service Organizations.** These firms were permitted to increase their prices to reflect allowable cost increases which had occurred since their last price increase but not before January 1, 1971. The cost increases were to be reduced to reflect productivity gains. Such price increases could not have the effect of increasing the firm's profit margin (profits before taxes as a percentage of sales) over its margin prevailing in a base period (defined as the highest average of two of a firm's 3 fiscal years ending prior to August 15, 1971);

2. **Retailers and Wholesalers.** These firms were permitted to increase their prices consistent with maintaining: (a) Their customary initial percentage markup on products equal to or less than that prevailing during the freeze period or (at the firm's option) during the firm's last fiscal year ending before August 15, 1971, and (b) the before-tax profit margin of the firm equal to or less than that prevailing in the base period (defined as for manufacturers, above).

These regulations had the effect of placing a ceiling on the firm's overall ratio of profit to sales, the ceiling being determined by the experience in the past 3 years. The formula for permissible price increases normally precluded an increase in the profit margin on individual products; in the event that product mix factors had the effect of increasing the firm’s overall profit margin, the ceiling became operative. However, absolute profits could continue to advance in step with expanded production and sales. Since the regulations applied to individual producers and sellers, competitive influences could continue to operate as an additional downward pressure on prices. This factor was immediately apparent in cases where some manufacturers’ effective price increases were below those justified by their cost increases because major competitors had been permitted a smaller increase. This
procedure also avoided the costly and time-consuming process of setting individual price ceilings for individual products, with attendant problems of product definition and of assembling and analyzing data.

Immediately after the freeze the Price Commission gave priority to decisions on requests from Tier I firms for price increases based on long-term contracts written before the freeze, on adjusted base prices, or on price adjustments posted or announced prior to August 15, 1971, as well as for price increases based on contractual wage and other cost increases where price adjustments had been deferred by the freeze. Other price increases calling for advance notification were to be dealt with on the basis of approval or disapproval by the Price Commission within 30 days.

**Labor Cost Pass-Through.** The Price Commission made clear soon after assuming its duties that it would not necessarily grant price increases reflecting the full amount of increases in labor costs, i.e., increases in wages and benefits minus gains in productivity. It promised “to look very carefully at any labor cost increase, even if allowed by the Pay Board, to determine its impact on price inflation,” and said that “in general” it would not recognize wage increases that exceeded the Pay Board’s basic standard.

**Rent.** Price Commission rules for increases in residential rents provided that the landlord could:

1. Increase his rent charge by 2½ percent annually above the base rental upon 30-days notice to the tenant.
2. In addition, increase his rent charge by the dollars-and-cents amount of the increase of State and local government taxes, fees, and charges for services allocable to the individual unit.
3. Increase monthly rents by 1½ percent of the total cost of major capital improvements made after August 15, 1971.
4. In the case of leases which had not been renewed within 90 days prior to August 15, establish a new base rent, defined as that in effect on May 25, 1970, plus 5 percent.

**Fire and Casualty Insurance.** Price Commission policies covering all non-exempt insurance coverage restricted projection of increases in company-controlled costs (as opposed to actuarial factors) to 2½ percent, limited the projection of inflationary trend factors to 62.5 percent of what they would have been in the absence of an economic stabilization program, stipulated that no changes could be made in ratemaking formulas which would increase rates and, in lieu of the general profit margin test, imposed a 2½-percent limit on increases in the profit portion of the premium. Insurance departments of the various State governments are responsible for administering these guidelines, although final authority to review rate increases remains with the Commission.

**Public Utilities.** Under the Price Commission’s rules all public utilities with $100 million or more in annual revenues in their most recent fiscal year were required to notify the Commission when they request a rate increase from their respective regulatory agency as well as when the increase is permitted.
to be effective; public utilities with revenues of between $50 million and $100 million were required to notify the Commission when they were granted an increase. The Commission relies initially upon certification by the regulatory agency that the increase conforms to criteria specified by the Commission; however, the Commission retains the right to disapprove an increase within 10 days after it has been granted.

**Firms Showing Losses or Low Profits.** Notwithstanding its other regulations, the Price Commission authorized all firms currently sustaining a loss to increase their prices to the break-even level. In addition, firms with annual sales of $1 million or less were permitted to increase prices to bring their profit margins on sales up to 3 percent regardless of their experience in the previous 3 years.

**Health Care Services.** The Price Commission approved policies for this sector recommended by the Health Services Industry Advisory Committee which operated under the jurisdiction of the CLC. The guidelines divided the industry into two categories: Institutional providers, such as hospitals and nursing homes, were to be permitted only such price increases as were justified by allowable costs adjusted for productivity gains. Increases from 2 1/2 to 6 percent had to be reported to the Internal Revenue Service with supporting justification and to the appropriate medicare intermediary; and increases above 6 percent required an exception granted by the Price Commission. Noninstitutional providers, including physicians, were permitted average aggregate increases in their prices, based on allowable cost increases, of no more than 2 1/2 percent per year. Such increases might not have the effect of increasing profit margins of the providers above the average of the highest two of the past 3 years. Nonprofit providers were not permitted to increase the ratio of their net revenues to their gross revenues as compared to the base-year average.

**Term Limit Pricing.** The Price Commission late in 1971 established a simplified approach to approvals for price increases by Tier I companies: Under the term limit principle (TLP) a company might apply for a weighted average price increase covering all product lines for a 12-month period without specific Commission approval of changes in individual product prices. This modification was particularly useful to firms with complex product lines which included thousands of individual items. The Commission required such a firm to keep records and file quarterly reports; and the firm had also to establish a monitoring procedure which would assure that the weighted average of increases did not exceed the approved limit.

**Prices, Fees, and Charges of Federal, State, and Local Governments.** The distinction between prices, fees, and charges on the one hand and the taxes levied by State and local governments on the other is often very arbitrary. Since taxes cannot be controlled under the economic stabilization authority, an inducement to raise taxes rather than increase fees might be present if the latter were controlled. Therefore, these fees (except those of
hospitals and public utilities) were exempted from control. However, all State and local governments were requested to take steps to make sure that such fees did not increase more than 2½ percent per year; their chief executive officers were also asked to report semiannually on fee increases. Similarly, the Federal Government was scheduled to report the fee increases at the end of each fiscal year.

**Interest and Dividends.**

Interest rates were lower during 1971 than 1970, and net borrowing by households and nonfinancial business units increased substantially. The decline of interest rates may have reflected some abatement of inflationary expectations. Despite the decline of interest rates there was considerable public concern about the future course of interest rates and the Committee on Interest and Dividends was directed by the CLC to maintain close surveillance of interest rates with a view to formulating and preparing to implement a program of voluntary restraints on such rates, particularly for home mortgages and consumer loans.

The Committee proposed voluntary compliance with dividend guidelines that requested that companies limit dividend increases to 4 percent per share in 1972 (adjusted for splits and stock dividends) over the largest per-share dividend paid in fiscal 1969, 1970, and 1971, or in calendar 1971. Various special guidelines carefully defined acceptable procedures where new companies, mergers, and special situations were involved.

**Pay Board Policies**

General policies governing pay adjustments were adopted by the Pay Board early in November. These became effective at the end of the freeze and were applicable to all employees other than Federal employees and persons earning less than the Federal minimum wage. These guidelines included three provisions. First, permissible annual pay increases would be those normally considered supportable by productivity improvement and cost-of-living trends. The initial general standard for new contracts and adjustments was set at 5½ percent and was subject to periodic review by the Board. Second, existing contracts and pay practices established before November 14 would be allowed to operate, subject to challenge by five members of the Board or a party at interest. Third, retroactive payments for wage increases temporarily foregone during the freeze would be permitted only upon approval of the Board.

The Pay Board delegated to the CISC the responsibility of carrying out Board policy with respect to the construction industry. The Board also agreed upon and issued a series of definitions. Among the most important of these were a base date (November 13) from which future wage increases were measured against the standard and definitions of employee units. The Board also waived reporting requirements for existing contracts until year's end, a deadline later extended to January 31, 1972.
In mid-November the Pay Board issued standards regulating certain permitted exceptions to the general 5½ percent pay standard. These exceptions provided that: (a) Pay increases of up to 7 percent would be permitted where tandem relationships (situations where pay rates for certain employees or firms are based on rates for other groups of workers or firms) could be proven to exist under certain stringent definitions. (b) Pay increases of up to 7 percent would be permitted where they were deemed necessary, within certain narrow criteria established by the Board, to attract or retain essential labor. (c) Pay increases of up to 7 percent would be permitted until March 31, 1972, where pay increases had aggregated less than the sum of 7 percent per year for each of the past 3 years (under this exception only the difference between the sum of 7 percent per year for 3 years and the sum of the actual increases might be added to the 5½ percent increase normally permissible). (d) The portion of a pay adjustment tied to changes in the cost of living might be calculated as a weighted annual average increase, provided that the sum of this portion and the remainder of the adjustment did not exceed the general pay standards. The first and second exceptions required prior approval by the Pay Board, and the maximum permissible adjustment, under any or all of these criteria, was not to exceed 7 percent.

Policies on executive and incentive compensation not covered by collective bargaining agreements were announced late in December. Essentially these provided that executive compensation increases (including salaries, fringe benefits, and perquisites of all types) were not to exceed the 5½ percent general standard. Existing incentive compensation and bonus plans were permitted to continue as long as their costs did not rise by more than 5½ percent from the appropriate base period. Existing stock option programs were permitted to continue if they met certain detailed legal and historical tests, including the stipulation that the number of shares made available should not exceed the average number made available during a 3-year base period. Also late in December, the five business members of the Pay Board reported their intention to challenge all deferred pay increases in excess of 7 percent called for by existing labor contracts.

Government Pay. Federal Government employees’ pay, subject to existing legislation and executive decision, was to be monitored by the Federal Pay Agent to ensure consistency with the stabilization program. The CLC was to advise the President on the consistency of future Federal pay decisions with the economic stabilization program. The pay of State and local employees was subject to the Pay Board’s rules but advance notice of such increases within the Board’s general standards was waived. If a governmental unit certified to the Pay Board that it would abide by the Board’s standards, it was required to report pay increases only semiannually.

PHASE II OPERATIONS

At yearend the economic stabilization machinery of Phase II had been operating about 7 weeks. Progress had been made by the Price Commission
and Pay Board in adopting and publicizing standards for price and wage behavior, in establishing criteria for evaluating individual cases, in recruiting and organizing necessary staff, and in setting up reporting procedures and internal systems for handling applications.

To expedite the evaluation of applications and to consider regulatory issues, the Price Commission had recruited a supporting staff of approximately 500 people, while the Pay Board, whose needs for staff were much smaller, had recruited 75. A stabilization office was established under the Internal Revenue Service; it utilized 360 local IRS offices with about 3,000 persons to administer, interpret, monitor, and enforce the wage, price, and rent regulations of Phase II. A special unit of the Justice Department provided legal support, with 170 people assigned to this task.

**Price Commission**

By early January there had been 3,460 advance notifications of price increases filed with the Price Commission by an estimated 1,075 companies (among the estimated 1,500 companies in Tier I). The Commission had approved requests of 335 industrial companies for price increases, covering products having a sales volume of $322 billion. (The total sales of all Tier I firms was estimated at over $800 billion.) A total of 27 companies were denied requested price increases. The approved increases averaged 2.9 percent on a weighted basis measured against sales of affected products by applicant companies and 1.4 percent of total sales of the companies covered. Companies receiving approval for increases were among the Nation's largest producers in the automotive, steel, aluminum, and coal industries.

The average approval rate should not be construed as a general indicator of the price behavior of all Tier I firms. In fact, at the end of the year, the trend shifted to lower approvals. In addition, many large companies had indicated to the Price Commission their intention to hold the line on prices.

The Price Commission was giving close attention to a more detailed articulation of the standards for price behavior, which would provide clear rules both for the large companies required to report to the Commission and for the millions of smaller businesses and individuals in the economy. Particular priority was accorded to interpretation of the requirement that "productivity gains" be taken into account.

**Pay Board**

Up to mid-January 1972, the Pay Board had received 114 applications for pay increases from prenotifying Tier I organizations. The Board had acted upon 16 applications, approving 11 and disapproving five. Two of the contracts that were approved—the coal contract and the railroad signalmen's contract—provided initial wage and benefit increases in excess of 10 percent. Both contracts represented special situations: The coal pact was actually signed before the November 13 deadline after which Phase II rules became effective and part of the signalmen's increase had been legis-
lated by the Congress. Deferred increases in both contracts are subject to review in 1972 and 1973. The Board had also approved a 4-percent increase for municipal workers in Chicago.

Early in January the Pay Board rejected five proposed contracts covering over 100,000 aerospace workers. The proposed contracts had provided first-year wage and benefit increases of about 12 percent. Also in early January the Board approved wage and benefit increases of less than 5 1/2 percent for workers in eight major organizations in the prenotifying category.

Inquiries, Complaints, and Litigation

Inquiries about various aspects of the stabilization program averaged over 24,000 per day from Phase II's initiation to mid-January. Inquiries about rent regulations accounted for more than half the total; the remaining inquiries were divided equally between wages and prices.

Complaints about alleged violations of Phase II rules averaged nearly 800 per day during Phase II, a somewhat lower volume than during the latter days of the freeze. Complaints about prices averaged 56 percent of the total; rent complaints were 40 percent and wage complaints 4 percent. The cumulative total of complaints during Phase II was over 30,000, of which about two-thirds had been resolved by IRS action. Of some 8,700 requests received for exemptions or exceptions from stabilization rules, over 2,500 had been resolved. The bulk of the remainder involved rent questions.

There were only a few court cases involving Phase II regulations by year-end. Two injunctions had been issued against threatened evictions and proposed rent increases. In a case covering Phase I and Phase II the Government had brought action against a municipal transit company to remedy violations involving fare increases and reduction of service.

Program Administration

Because of the newness of the controls and systems, as well as the new staffs and procedures, there was some early confusion in the control system and some misunderstanding. Probably the most notable example of confusion involved specific price ceilings and the lists of base prices (applicable during the freeze period) which the Price Commission required each retailer to post. Under the regulations, prices of the same product could vary from store to store, and products essentially similar sold by different firms could also vary in price. Moreover, the legal ceiling prices in retail stores could vary with fluctuations in the stores' wholesale purchase prices. During earlier periods of price controls, ceiling prices were set by product and were therefore more uniform. Under the present system it was difficult for the public to assess accurately whether actual prices, when they were above the posted base price, had been increased in accordance with Price Commission regulations or not. Therefore, in cases where prices increased substantially beyond the posted base price the public was encouraged to ask the store to explain the increase. If not satisfied, the consumer could file a complaint with the IRS stating the basis for his complaint.

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In the final analysis, however, effective enforcement depended on the advance notification, reporting, and spot-check system, which permitted the authorities to analyze cost and profit data.

EXTENSION OF THE STABILIZATION AUTHORITY

The Economic Stabilization Act of 1970—the legal basis for the freeze and Phase II control programs—was scheduled to expire at the end of April 1972. In response to a Presidential request, the Congress extended the Act to April 1973. Extension of this authority provides sufficient continuity and duration of the stabilization program to permit it to succeed. In extending the Act, however, the Congress substantially amended it, and some provisions of these amendments may significantly modify certain policies developed under the initial economic stabilization program. Under the revised Act:

1. Wage and salary increases which were scheduled to take effect after the freeze according to contracts entered into before August 15, 1971, were to be paid unless "unreasonably inconsistent" with Pay Board standards.

2. The President was directed to take action to permit wage and salary increases which were scheduled to take effect during the freeze according to contracts negotiated prior to the freeze, but not paid because of the freeze, to be paid retroactively unless "unreasonably inconsistent" with Pay Board standards.

3. The President was directed to take action to require the retroactive payment of wage and salary increases provided for by law or contract prior to August 15, 1971, where prices had been advanced, productivity increased, taxes had been raised, appropriations had been made, or funds had otherwise been raised or provided for in order to cover such increases, regardless of Pay Board standards.

4. Employer contributions to pensions, profit-sharing, annuities, and savings plans qualified under the Internal Revenue Code, as well as contributions to group insurance and disability and health plans were not to be included in the definition of "wages and salaries" for control purposes unless they were "unreasonably inconsistent" with standards for wages, salaries, and prices.

5. Wage increases to any individual whose earnings were substandard or who was a member of the working poor were not to be limited in any manner, until such time as his earnings were no longer substandard or until he was no longer a member of the working poor.

ASSESSMENT

The Economic Stabilization Act requires this Report to give "an assessment of the progress attained in achieving the purposes of this title." As stated in the Act, the aims are "to stabilize the economy, reduce inflation, minimize unemployment, improve the Nation's competitive position in world trade, and protect the purchasing power of the dollar."

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These purposes cannot be achieved by operations under the Economic Stabilization Act alone. The freeze and Phase II contribute to their attainment as part of a combined program which also includes fiscal and monetary measures, exchange rate readjustment, and trade measures. The relation of the wage-price controls to the rest of the package is important. If monetary and fiscal policy keep the growth of demand moderate, the price and wage controls can bring about more quickly and surely the lower rate of inflation that competitive forces would cause in such circumstances. But if demand is allowed to grow excessively, the price and wage control system will lose its value. Correspondingly, if the presence of the price and wage control system becomes an excuse for laxity in monetary-fiscal policy, the system’s effect on controlling inflation will be negative.

As discussed in Chapter 3, we believe that the combination of policies in effect in 1972, including the price-wage control system, will produce substantial progress toward the goals of the Stabilization Act. The goals may be summarized as less unemployment, less inflation, and a U.S. economy which is more competitive in international markets. In this section of the Report we concentrate on the contribution of the steps taken under the Economic Stabilization Act.

Evolution of Prices and Wages

In the accomplishment of its own objectives, the freeze was an unqualified success. It had the desired shock effect on the public’s inflationary psychology, and it held the line on prices and wages, allowing time for a more flexible and durable system to be devised and put in place. The statistical evidence on price behavior during the freeze is presented in Tables 20, 21, and 22.

Assessment of Phase II is obviously more difficult. It has been in operation too short a time to generate any substantial body of evidence, statistical or other, about its effects. The data on prices and wages for December, the latest available, are not a measure of the effectiveness of Phase II and should not be so interpreted. A temporary period of faster than desired wage and price increases was an inevitable byproduct of decisions made with respect to the transition from the freeze to Phase II. Several months of experience are required before Phase II regulations and rulings will be fully reflected in price and wage trends. At this time, therefore, the future outcome of policies which have only just been inaugurated is chiefly a matter of speculation. The principal questions are: Will the standards of the Pay Board and the Price Commission lead to the desired results? Will the standards be observed?

The standards announced by the Pay Board and the Price Commission imply the following arithmetic: If compensation per hour of work rises by 5½ percent per annum, and if output per hour of work rises by 3 percent per annum, labor costs per unit of output will rise by approximately 2½ percent per annum. If prices rise in the same proportion as labor costs, which are the largest element in total costs for the economy as a whole, then prices will also rise by 2½ percent, a rate within the range of the goal set by the CLC.
Pay Board Decisions

A number of important factors must be taken into account in assessing the prospects of achieving the goal. The basic standard of the Pay Board is a 5½ percent permissible pay increase. Under certain circumstances, however, existing Pay Board regulations permit increases in excess of this average standard. One of the most important of these exceptions is the rule that permits wage increases scheduled under existing contracts to be granted, even if they exceed 5½ percent, unless they are challenged by five members of the Board or a party to the contract; in that case they will be reviewed by the Board. If all the known deferred increases in excess of 5½ percent that are scheduled for 1972 under major collective bargaining situations were granted and increases arising from cost-of-living escalator clauses were restrained by a small rise in the CPI (2 to 3 percent), they would add about 0.25 percent to the average rate of pay increase for the year (i.e., if the average outside of situations providing deferred increases were 5.5 percent and scheduled deferred increases were all granted, the average rise in hourly wages for all private sector workers would be about 5.75 percent). The business members of the Pay Board have indicated their intention to challenge all deferred increases in excess of 7 percent. If all known deferred increases that are in excess of 7 percent were limited to 7 percent, then deferred increases would add a little more than 0.1 percent to the average rate of wage increase in 1972.

The Pay Board rules also permit increases in excess of 5½ percent if they are necessary to bring the cumulative increase during the last 3 years to 7 percent a year, or to preserve certain limited traditional relationships with other wages, or to attract labor in shortage situations. Pay increases allowed under any or all of these exceptions may not exceed 7 percent (that is, 1½ percent above the general standard) and the 3-year catchup provision expires on March 31, 1972. While the direct impact on increases in compensation for the entire economy of these exceptions probably will be small, their impact through tandem wage relations and relative wage pressures could be significant.

As this Report is written, the Cost of Living Council has not yet issued an interpretation of the terms of the Economic Stabilization Act which excludes from control substandard wages and wages of the "working poor." Neither has the Pay Board interpreted the exclusion of increases in certain fringe benefits unless they are "unreasonably inconsistent with the standards for wage, salary, and price increases."

The foregoing are all provisions of the regulations which would permit wage increases to exceed 5½ percent in certain circumstances. Moreover, even if no particular wage rate rose by more than 5½ percent, the average compensation per hour of work could rise by more than that percentage because of increased overtime or a more than average increase in employment in sectors where wage rates are above the average. Both of these causes tend to operate in a period of economic expansion such as is envisaged for
1972. In addition, labor costs per hour of work will rise slightly in 1972 from an increase in employers' Social Security contributions arising from an increase in the taxable earnings base.

On the other hand, and this point is most important, the standards of the Pay Board are only the standards of permitted wage increases, not the standards of required wage increases. Certainly in the conditions of 1972, when labor shortages will be highly infrequent, we should expect many wage increases to be below the normally permissible amount. In 1970, when the average wage increase in large union contracts was 8.8 percent, 22 percent of all the workers covered by such contracts received increases below 5 percent. If in 1972 it develops that 5½ percent is the standard, or most common, wage increase, there will be many increases below that, including many instances of no wage increase at all. Some support of this expectation may be found in the fact that several of the pay increases approved thus far by the Pay Board have been significantly below the standard.

Our expectation is that the combination of the Pay Board rules and the natural forces at work will, after the initial post-freeze bubble, hold the rate of increase of compensation per hour close to 5½ percent. Certainly the rules themselves contain nothing which makes this rate clearly unobtainable. However, the course of events and decisions will have to be closely observed to see what wage outcome is in fact being generated by the system.

Unit Costs

The simple arithmetic outlined above assumed that output per hour of work in the private economy would rise by 3 percent per annum, which is about the average rate of the post-World War II period. The rise of productivity was below average in 1969 and 1970 but faster in 1971; it could reasonably be expected to be even higher in 1972, since the rate of increase in productivity commonly exceeds the historical average in years of strong expansion. One reason is the same as that which makes the rate of increase of average compensation relatively high—a shift of employment and output to industries with above-average productivity and wages.

Thus it seems not inconsistent with the existing rules that the rate of increase of labor cost per unit of output should be in the range of 2 to 3 percent. Other costs will also be taken into account in the price ceiling formula—notably depreciation costs, indirect business taxes and interest. The anticipated rate of increase of these nonlabor costs combined in 1972 would probably not be so large as to force the rate of increase of total costs per unit of output outside of the 2- to 3-percent range.

Price Commission Decisions

Whether the average behavior of prices will, in fact, approximately follow the behavior of unit costs is an important question. Under the general rules of the Price Commission, price increases are permitted in proportion to cost increases. However, there are several circumstances in which permitted price increases may be either larger or smaller than actual cost increases.
1. Prices may not be raised as much as costs if the effect would be to raise the net profit margin above that of the best two of the past 3 years.

2. The Price Commission will not automatically recognize all cost increases in calculating “allowable cost” for determining permitted price increases.

3. The price regulations for wholesale and retail trade do not permit such firms to pass on cost increases except increases in the costs of purchased goods.

4. The operation of the term limit principle may result in a firm’s acceptance of a smaller average permitted price increase than its costs would justify in order to qualify for use of simpler and more flexible procedures.

5. If it is necessary to use industrywide trend estimates of productivity, in the absence of other information, in projecting costs, permitted price increases will turn out to be larger or smaller than actual cost increases where the actual productivity increase is larger or smaller than the estimate used. In a period when actual productivity rises may be exceeding the trend, this would mean price increases exceeding cost increases, on the average, but this effect would be limited by the profit margin ceiling.

6. As a result of specific exemptions by the CLC or the statute, items in the CPI comprising 21 percent of its total weight are not controlled by the Price Commission.

7. Public utilities may be granted above-standard rate increases where necessary to meet essential service demands.

8. Exceptions from the general cost-justification rule have been provided for firms with losses or very low earnings.

9. If costs decline, the system does not require price reduction unless the “windfall profit” situation is encountered.

In the foregoing circumstances, and possibly others, legally permitted price increases may be greater or less than cost increases. The net of all this is impossible to estimate. Without more experience no more can be said than that the rules and procedures do not seem inconsistent with permitted price increases coming out on the average fairly close to permitted cost increases.

The actual behavior of prices will be determined not only by what the Price Commission permits but also by what the market permits. The limitation of the market, including competition by firms with relatively small cost increases, will work in the direction of holding price increases below those legally permitted.

Although much remains to be seen, a reasonable judgment at this time is that the standards so far promulgated, applied in the context of strongly-rising productivity without excess demand, are probably consistent with achievement of the anti-inflation goal for the end of 1972. This is not, of course, inconsistent with the expected bulge of prices in the early part of the year as the transition from the freeze is completed. The longer-run effect of the present standards will depend on specific policy decisions and interpretations by the control authorities, as well as on the cooperation of business and labor. And the outcome of the system as a whole will depend on the
ability to amend the rules if it should appear that the existing rules are not leading to the desired end.

**Compliance**

A further question which must be asked is whether the rules of the system are likely to be observed by businesses, landlords, and unions. In fact, the question is twofold: Whether the rules will be overtly defied, and whether they will be covertly evaded. This issue also allows only a judgment on the basis of limited experience. Overt defiance seems unlikely, given the extensive support for the system which seems to prevail among the public and the legal sanctions provided by the Economic Stabilization Act. Evasion may be a greater problem. A control system is imposed upon millions of economic units by an administrative staff of 3,000 or 4,000. Whether control measures can succeed will depend upon three things:

(a) The continued belief of the American people that compliance with the program is essential to the national interest;

(b) The ability of the managers of the system to devise self-executing rules;

(c) The judgment of the Cost of Living Council in excluding from the system, at the appropriate time, sectors of the economy which do not add greatly to inflation but make important inroads on the resources of the control system. In mid-January, the CLC moved along this path by exempting from coverage all retailers with annual volume of less than $100,000 and, under certain circumstances, rental units owned by individuals with fewer than four such units. Exclusion of these numerous small units from coverage will permit the administrators of the controls system to focus their efforts and resources on large economic units which have a far greater impact on markets and whose competition will in turn limit price increases by the uncovered units.

On the basis of the experience so far, we believe that the program will help achieve the economy’s transition to a situation in which reasonable price stability can be expected without controls. The outcome will depend in large part upon decisions made, and still to be made, by the Cost of Living Council, the Pay Board, and the Price Commission. However, it will depend even more upon the support and self-restraint of the American people. This is the inescapable character of the system.
CHAPTER 3

Outlook and Policy

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

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

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

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

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

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

DEVELOPMENTS IN THE FOURTH QUARTER OF 1971

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

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

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

Investment expenditures also rose in the fourth quarter. Fleet sales of cars were very strong, as were purchases of trucks. New orders for producers' capital equipment averaged 4 ½ percent higher during September to November than in the 3 preceding months. Housing production in the fourth quarter continued to show great strength; starts in December reached a seasonally adjusted annual rate of 2.5 million units, bringing the average rate for the quarter to 2.3 million units. Investment in business inventories, which had declined by $1 billion in the preceding quarter, rose by $2 billion.

The New Economic Policy induced a sharp rise in automobile sales. Prior to the August 15 announcement, sales of domestic-type new cars were running at a seasonally adjusted annual rate of about 8 million units. In September, sales rose to a rate of 10.8 million and in October to 10.0 million; the rate fell noticeably after mid-November when the price freeze ended. For the fourth quarter as a whole, sales were not greatly different from the third quarter rate, but the rate from September through December was 17 percent higher than the average for the 3 months immediately preceding the NEP. Some of the early rise was at the expense of foreign car sales and subsequent domestic sales.
THE OUTLOOK FOR 1972

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

Business Fixed Investment

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

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

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

Inventory Investment

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

Residential Construction

The total number of private housing starts in 1972 is expected to be 2.2 million units. Within this total, single-family units are expected to be much stronger than starts of multifamily units. This shift from multifamily to single-family units will strengthen total residential outlays in 1972, which are expected to exceed 1971 by 15 percent or more.
In early 1972 market interest rates continued the declines which began in 1971 and financial intermediaries continued to enjoy heavy inflows of new deposits. These developments provided increased funds for home mortgages and induced a decline in mortgage interest rates. The outlook for the remainder of 1972 is that the availability and cost of mortgage funds will remain at levels that would be unlikely to limit the expansion forecast for the housing sector.

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

**Net Exports**

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

**Government Purchases of Goods and Services**

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

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

**Personal Consumption Expenditures**

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

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

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

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

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

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

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

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

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

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Major Uncertainties

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

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

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

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

PRICES AND PRICE-WAGE POLICY

The rate of inflation in 1972 (as measured by the GNP price deflator) is expected to fall to about 3½ percent, the lowest year-to-year change since 1967. Toward the end of the year the rate of price change is expected to be 2–3 percent per annum.

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

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

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

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

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

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

EMPLOYMENT AND UNEMPLOYMENT

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

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

Reduction of the unemployment rate in 1972 is a primary objective of this year's economic policy. It is to this end that the Government is pursuing a highly expansive fiscal policy. And it is in large part to this end that prices and wages are controlled, so that the expansion of demand will generate more jobs, not more inflation.
Concern with unemployment is also the primary motivation behind a large variety of other Government efforts, more specialized in their impact but nevertheless critical for achieving full employment. Many of these are now focused on the problems arising in the transition from high levels of military and civilian employment in national defense.

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

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

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

<table>
<thead>
<tr>
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<th>1969 IV</th>
<th>1970 IV</th>
<th>1971 IV</th>
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</thead>
<tbody>
<tr>
<td><strong>Veterans:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civilian population</td>
<td>2,990</td>
<td>3,696</td>
<td>4,293</td>
</tr>
<tr>
<td>Labor force</td>
<td>2,752</td>
<td>3,383</td>
<td>3,931</td>
</tr>
<tr>
<td>Employment</td>
<td>2,621</td>
<td>3,115</td>
<td>3,626</td>
</tr>
<tr>
<td>Unemployment</td>
<td>130</td>
<td>269</td>
<td>305</td>
</tr>
<tr>
<td>Unemployment rate (percent)</td>
<td>4.7</td>
<td>8.0</td>
<td>7.8</td>
</tr>
<tr>
<td><strong>Nonveterans:</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Civilian population</td>
<td>8,589</td>
<td>9,068</td>
<td>9,567</td>
</tr>
<tr>
<td>Labor force</td>
<td>7,334</td>
<td>7,810</td>
<td>8,200</td>
</tr>
<tr>
<td>Employment</td>
<td>7,089</td>
<td>7,281</td>
<td>7,633</td>
</tr>
<tr>
<td>Unemployment</td>
<td>245</td>
<td>529</td>
<td>567</td>
</tr>
<tr>
<td>Unemployment rate (percent)</td>
<td>3.3</td>
<td>6.8</td>
<td>6.9</td>
</tr>
</tbody>
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Note.—Detail will not necessarily add to totals because of rounding.
Source: Department of Labor.
to State and local government payrolls, is designed both to meet the need for improved public services and to provide transitional career employment opportunities for jobless workers, especially veterans and the disadvantaged. At year's end, funds had been provided for about 128,000 positions, and about three-fifths of the jobs had been filled.

Retraining and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and technic Peace and job-finding services for engineers, scientists, and techni
of the workforce, and provide disadvantaged workers with opportunities to improve their well-being. Although already constructive, these manpower programs can be greatly improved by making them more flexible, innovative, and most importantly, responsive to local conditions and needs. This could be accomplished by passage and implementation of the President's proposed Manpower Revenue Sharing Act, which is now under consideration by the Congress. This Act would (1) consolidate most manpower-type programs under a single large-scale program, (2) eliminate most narrowly-targeted categorical grants, (3) shift detailed program decisionmaking from Washington, D.C., to State and local governmental units, and (4) increase training investments.

**INFLATION AND UNEMPLOYMENT IN THE LONG RUN**

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

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

**THE CONTROL OF DEMAND**

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

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

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

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

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

VIEWS OF THE INFLATION AND UNEMPLOYMENT PROBLEM

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

The problem might take one or more of three forms:

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

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

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

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

CHARACTERISTICS OF THE LABOR FORCE

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

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

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

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

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

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

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

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

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

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

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

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

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<tbody>
<tr>
<td>Hypothetical unemployment rates:</td>
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<tr>
<td>Using 1956 age-sex rates</td>
<td>4.1</td>
<td>4.2</td>
<td>4.4</td>
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<td>4.4</td>
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<tr>
<td>Percentage distribution of civilian labor force:</td>
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<tr>
<td>Civilian labor force</td>
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<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
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<tr>
<td>Females</td>
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<tr>
<td>16–19 years</td>
<td>32.2</td>
<td>33.8</td>
<td>36.0</td>
<td>38.2</td>
<td>37.7</td>
</tr>
<tr>
<td>20–24 years</td>
<td>2.8</td>
<td>3.0</td>
<td>3.8</td>
<td>3.9</td>
<td>2.9</td>
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<tr>
<td>25–54 years</td>
<td>3.7</td>
<td>3.8</td>
<td>4.7</td>
<td>6.0</td>
<td>5.7</td>
</tr>
<tr>
<td>55 years and over</td>
<td>20.6</td>
<td>21.2</td>
<td>21.3</td>
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<td>23.0</td>
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<tr>
<td>Males</td>
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<td></td>
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<td></td>
</tr>
<tr>
<td>16–19 years</td>
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<td>66.2</td>
<td>64.0</td>
<td>61.8</td>
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<tr>
<td>20–24 years</td>
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<td>4.9</td>
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<tr>
<td>25–54 years</td>
<td>5.2</td>
<td>6.0</td>
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<td>7.5</td>
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<tr>
<td>55 years and over</td>
<td>45.6</td>
<td>43.8</td>
<td>41.0</td>
<td>38.6</td>
<td>41.5</td>
</tr>
</tbody>
</table>

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

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

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

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

The fact that the amount of "transitional" unemployment may be rising implies something about what can be achieved by general expansive measures alone, although the full implication will not be known until we can observe the behavior of unemployment in the current expansion. However, these developments also imply the need to do more directly about transitional unemployment. In fact, over the past 10 years Federal efforts to deal with this problem have increased substantially, and this Administration has supported intensification and improvement of these efforts.
CHAPTER 4

Effective Use of Resources

While programs to deal with the problems of inflation, expansion, and the balance of payments captured the spotlight during 1971, measures to assure the efficient use of our resources and productive capability continued to be an important feature of economic policy. Two conditions must be met if the performance of the U.S. economy is to match the rising demands placed upon it: Our productive resources must be employed efficiently in producing each good or service, and the economy should produce the combination of goods and services most preferred by society.

In many sectors of the economy the discipline of the competitive market is enough by itself to ensure efficiency. In certain areas, however, resources may not be allocated efficiently without at least some Government intervention. The proper nature and degree of Government intervention in such sectors is always a central issue in economic policy. Changing circumstances mean that Government must continually reexamine its role.

All the segments of the economy covered in this chapter are under critical review to determine the Government's proper role. In some instances, such as energy and transportation, certain aspects of Government regulation prevent the best use of resources. In other cases, such as environment and pollution, the Government's role is being expanded to prevent overuse of environmental resources by other sectors of the economy. Finally, there are sectors such as health and research and development where the evidence suggests that Government's role should be redirected.

NATIONAL COMMISSION ON PRODUCTIVITY

Large demands will continue to be placed on the Nation's total resources in the future. In order to respond to these demands, today's private decisions and public policies must be formulated to foster tomorrow's productivity of the Nation's resources.

Productivity can be defined in a variety of ways, the most common one being real output per hour of work. This definition gives a rough measure of how well we use our most important productive resource. A more comprehensive definition of productivity is output per unit of all resources. This definition is more suitable for topics in this chapter because they deal with selected adjustments that would improve the total output of goods and services produced from our capital, labor, and natural resources.

Historically, there has been a steady improvement in productivity. Much of this progress has been achieved through incentives within private markets. Yet private markets do not ensure that all potential productivity gains are
achieved in the private sector, nor can they be expected to bring about improved productivity of resources employed in the public sector.

Recognizing the importance of achieving improvements in productivity, the President established the National Commission on Productivity in June 1970. The Commission is composed of representatives from industry, labor, agriculture, the public, and Federal, State, and local governments. The Commission makes recommendations to the President for actions to improve productivity in the public and private sectors.

The responsibilities and duties of the Commission were substantially expanded by the Economic Stabilization Act Amendments of 1971.

During 1971 the Commission gave primary attention to four specific aspects of productivity:

1. "Productivity Bargaining" Between Labor and Management. Such bargaining focuses on mutually beneficial agreements that enhance labor's productivity. The Commission believes that bargaining practices should give greater attention to work rules, group incentives, work scheduling, job enrichment, and other practices that can improve productivity.

2. Manpower Adjustment Policies. Improvements in productivity lead to higher average incomes, but they can also result in dislocations for individual workers. The Commission believes that public and private adjustment policies should be strengthened and refined to make the human costs of change, where they exist, less burdensome.

3. Education and Research and Development. Since productivity is closely linked with education and with research and development, the Commission has studied current institutional arrangements that may inhibit desirable performance in these fields and believes that added incentives for experimentation and innovation in such arrangements would be advantageous.

4. Government Productivity. Government employment is expected to continue to grow rapidly in the future, particularly at State and local levels. The Commission believes that greater attention should be given to improving the productivity of government employees in order to increase efficiency and reduce costs for this expanding service sector of the economy.

ENERGY

The growth in consumption of fuels by automobiles, electric generating plants, homes, and factories is closely associated with increases in our material levels of living. Historically, however, energy use has not grown as rapidly as GNP. While real GNP (in 1958 dollars) rose from $183.5 billion in 1930 to $617.8 billion in 1965, for a compound annual growth of 3.5 percent, energy consumption rose from 22.3 quadrillion btu's to 54.0 quadrillion btu's during the same period, an annual growth rate of only 2.6 percent. The use of energy per dollar of GNP (again in 1958 dollars) therefore fell from 121,500 btu's in 1930 to 87,400 in 1965.

During this same period energy was becoming cheaper relative to other goods and services. While the price index of all goods and services (the GNP
deflator) rose 125 percent during this period, the wholesale price index of fuels and electric power rose only 70 percent. Thus, although energy consumption was growing it was not growing as rapidly as GNP, and although energy prices were rising they were not rising as fast as the prices of other goods and services.

Since 1965, however, a sharp upturn in the energy-GNP ratio has occurred. From 87,400 btu's used per dollar of real GNP in 1965, the number rose to 95,600 in 1970. While output for the economy as a whole was growing at 3.1 percent per year, energy consumption grew at 5.0 percent. This sharp upturn in energy use was associated with a more rapid increase in prices. Prices of fuel oil and bituminous coal, in particular, rose sharply in 1970.

These developments gave evidence of at least a short-run shift in energy demand and prices. At the same time more fundamental changes were occurring in the domestic supply picture that were less noticeable to the typical consumer. Between 1960 and 1969 crude oil production was steadily rising, but the size of proved reserves actually fell in absolute terms. At current rates of production, proved reserves declined from 12.8 years of production in 1960 to only 9.3 years in 1969. The addition of the enormous Prudhoe Bay field in Alaska to the 1970 statistics increased our proved reserves by almost one-third, but this oil will not be available unless it can be transported to market in an environmentally acceptable way.

Natural gas reserves have also been falling in recent years. Proved reserves in 1970, including the natural gas associated with oil in the Prudhoe Bay field, were lower than in 1967. With production of natural gas rising at 5.4 percent per year since 1960, reserves have fallen from 20.1 years of annual production in 1960 to 13.2 years in 1970. The importance of these developments is underlined by the fact that domestic oil and gas contributed almost two-thirds of our energy supply in 1970.

The accelerated growth in energy demand relative to GNP in recent years is not expected to continue. Most observers forecast an annual average growth in energy consumption of just over 4 percent, paralleling the expected growth in GNP. A comparison of earlier forecasts and current realities, however, suggests that any assumptions about future demand and supply must be regarded as tentative, to be modified as new evidence becomes available.

Future energy problems involve even more than a growing demand in relation to supply. The Nation will not only consume more energy in the future but will also insist that this energy be cleaner. The full social cost of producing, transporting, and consuming energy should be counted in decisions about how much of each kind of fuel to use. If this were done it would result in a new pattern of fuel consumption. Natural gas, a sulfur-free fuel, would face soaring demands, while coal consumption processes would have to be improved to reduce harmful emissions.

Recognizing the Nation's growing energy problem, the President on June 4, 1971, sent an energy message to Congress, the first Presidential message devoted exclusively to this subject. Some initiatives in the message
emphasize direct measures to increase the supply of clean energy: Development of the nuclear breeder reactor, acceleration of oil and gas leasing on the Outer Continental Shelf, a leasing program for our oil shale and geothermal resources, expansion of our uranium enrichment capacity, and support for other efforts in energy research and development.

Other actions included in the message will indirectly help to expand potential supply. For example, support for developing sulfur oxide control devices will lead to clean uses of our abundant coal resources, and a system of planning the sites for our power plants and transmission lines will help to reconcile the need for energy with environmental demands. The President has also announced steps to conserve energy by requiring better insulation on federally insured homes. To balance energy and environmental needs, he also proposed a tax on sulfur oxide emissions to help ensure that the full social cost of energy consumption is built into the price of energy.

Despite much discussion about an energy problem, even an "energy crisis," the problem is not always precisely stated. The problem is that domestic supplies of environmentally acceptable energy are becoming ever more scarce in the face of a growing demand. This scarcity can manifest itself in three ways. In markets where prices are permitted to equate supply and demand, upward pressures on prices may develop. In markets where prices are not permitted to rise to equate supply and demand, shortages may emerge in the form of gaps between desired consumption and actual supply. If imports are not restricted, there will be increased dependence on foreign sources. Because some of these sources may be insecure, the Nation will be exposed to supply disruptions or costs incurred from domestic stockpiling to guard against potential interruptions in imports. Depending on the market, therefore, the problem may take the form of rising prices, shortages, or reliance on uncertain foreign supplies.

Insofar as price increases are needed to call forth supply they are a proper response to an underlying condition of scarcity. An example would be the worldwide increases during 1970 in the prices of heavy fuel oil, particularly the low-sulfur type. A temporary scarcity of tankers and limited facilities for refining and desulfurization, coupled with rapidly accelerating demand, caused the price of fuel oil to rise sharply. As tanker rates returned to more normal levels, price declines began to occur. During the entire episode of high prices, however, there were no cases of domestic shortages that some had feared.

Currently a shortage does exist in the natural gas market. Wellhead prices of gas for interstate delivery, which are regulated by the Federal Power Commission (FPC), have not been high enough to induce a supply equal to the growing demand. As a result not only has the demand itself been unmet, but there have also been geographical distortions in the consumption of gas, higher prices for competing fuels, and greater difficulty in meeting our environmental goals.

Because gas marketed in the State in which it is produced has not been subject to FPC price controls, producers have found it more attractive to
commit new reserves to intrastate markets. From 1963 to 1970, reserves earmarked for interstate markets fell by 18.4 trillion cubic feet. Comparable statistics for intrastate commitments do not exist, but the fact that the estimated total for proved reserves, excluding Alaska, fell by only 12.9 trillion cubic feet suggests that intrastate commitments may actually have risen. Although residential consumers in the East and Midwest might have been willing to outbid intrastate buyers, they have not had the opportunity to do so. Electric generating plants in the major gas-producing States of Louisiana, Oklahoma, and Texas, which could have been designed to use other fuels, are fueled almost entirely by natural gas. Thus, some markets lack gas because of artificially low ceiling prices, whereas in other markets this fuel is used excessively and its price is depressed to the level of interstate ceiling prices.

It is sometimes argued that low ceiling prices for gas result in low prices for competing fuels. Actually, the opposite is more likely to be true. Large supplies of gas would tend to depress prices of both gas and competing fuels, so that in those circumstances low gas prices would be associated with low prices of competing fuels. But artificially low gas prices lessen supply and create shortages. Since unmet demands for gas are transferred in part to other fuels, the result is greater demand and higher prices for these other fuels. The gas shortage itself therefore contributes to price increases in other energy markets. Indeed, the sharp increases in the price of low-sulfur fuel oil in 1970 came about partly because natural gas supplies were unable to respond to the increased demand for clean fuels.

The Nation's gas shortage is particularly serious at this time; large metropolitan areas badly need more gas if they are to meet air quality standards. Not only is the total supply of gas reduced by low ceiling prices, but the available supply tends to be used disproportionately in intrastate markets where acceptable air quality is ordinarily less difficult to achieve.

In the past 2 years the FPC has taken steps that could increase gas supplies. New ceiling prices, substantially above the prices previously authorized by the Commission, have been set for each of the major production areas. Weighted by area production, new wellhead ceiling prices average about 24 cents per thousand cubic feet, compared to 18 cents for previously authorized prices. The Commission has also issued a ruling that small producers, who together accounted for about 13 percent of 1969 production, shall be exempt from ceiling prices.

Despite these steps toward prices that more nearly reflect the market situation, important policy issues remain. The large interstate pipeline companies, being unable to meet their customers' demands with domestic natural gas and pipeline imports from Canada, are turning toward imports of natural gas in liquefied form from overseas and to synthetic gas produced from imported crude oil and naphtha. Although these imports would tend to increase the supply, they cost far more than supplies from conventional domestic sources. Prices at the refinery or vaporization plant would frequently be $1 or more per thousand cubic feet. Delivered to the same markets,
domestic natural gas at new ceiling prices would cost about half that amount. Thus, we could afford to pay significantly more for domestic gas, thereby appreciably increasing its supply, and still have lower prices than would have to be paid for gas from the alternative sources now being considered.

ENVIRONMENTAL QUALITY

Environmental resources are common property: They are free for those who use them, and thus are not rationed as they would be if they were private property and users were required to pay a price for their use. As a consequence such environmental resources as clean air and water have been overconsumed in certain uses, particularly the disposal of growing amounts of industrial, municipal, and agricultural wastes. The same excesses have been evident in thermal and noise pollution. The right to dump noise into the air, for example, carries no discipline of a price that must be paid to encourage restraint or to compensate others adversely affected by such pollution.

The question is, How can Federal, State, and local governments limit the uses of environmental resources so as to balance their value for such different purposes as breathing, drinking, recreation, natural beauty, and absorption of wastes? In assuming this task, governments face two major problems. First, the value of environmental resources in alternative uses must be assessed to provide a basis for determining a balanced use pattern. Second, governments must design rules that will achieve a balanced use at the least cost to the economy. The economic efficiency of different approaches to this rationing problem was examined in the 1971 Economic Report of the President.

The pending decision about issuing a right-of-way permit to the Trans Alaska Pipeline illustrates the considerations involved in government allocation of environmental resources. On the one hand, there are urgent energy needs that would be served by the large supplies of low-cost crude oil from the North Slope. The Prudhoe Bay field is one of the largest and one of the lowest-cost oil fields discovered by man. Its development would supply additional domestic energy to the West Coast of the United States at costs to the Nation well below those of less secure imports. On the other hand, the pipeline would pass through some of the most remarkable wilderness areas in the United States, and there is no certainty that environmental contamination could be avoided altogether.

The Secretary of the Interior, as custodian of the public lands, must decide whether to issue the right-of-way permit. To help him assess the costs and benefits of alternative decisions, the Council of Economic Advisers examined the economic costs to the Nation of not building the pipeline. Other agencies reported on such matters as the effects of the pipeline construction on the Alaskan economy, the impact on our national security, and the possibility of pipeline failures. According to the National Environmental Protection Act, the Secretary of the Interior himself must file a state-
ment with the Chairman of the Council on Environmental Quality describing the probable environmental impact of the action. Having completed these tasks, he will then be in a position to make a decision based on full consideration of the costs and benefits.

In calculating the labor and capital costs to the Nation of not building the pipeline, the Council of Economic Advisers compared the pipeline project with one of the other principal ways of meeting the Nation's demands for low-cost energy—importing the same amount of oil from overseas as would be produced at Prudhoe Bay. According to the Council's study, the real resource cost of imported oil would be more than twice that of the Prudhoe Bay crude delivered to the West Coast. Development of the 10-billion-barrel field and transportation of the oil to the West Coast would save the Nation $15 billion to $17 billion during the expected 20-year life of the field. These costs must of course be weighed with other considerations mentioned above in arriving at an ultimate decision.

Most environmental decisions are not of an all-or-nothing character. Instead, they involve setting quantitative limits on the use of our environmental resources, assessment of charges for use, or the distribution of subsidies to parties investing in facilities to control pollution.

These cases offer a wide range for judgments about where incremental costs and benefits will come into balance. In the control of water pollution, for example, costs of improvements rise more rapidly as we approach the total elimination of pollutants. According to estimates made by the Environmental Protection Agency, 85 to 90 percent of water pollutants from municipal and industrial sources can be removed by 1982 with aggregate new expenditures of just over $60 billion during the next decade. To remove another 10 percent would cost almost another $60 billion; to achieve zero discharge of pollutants would cost roughly $200 billion more, or over $60 billion for each percentage point of additional removal. At this level, the incremental cost is so enormous as to raise serious questions about the appropriateness of carrying removal this far. The substantial resources that would be needed to improve effluent quality only slightly beyond levels of purity that would already be high could be used to benefit the economy in dozens of more significant ways. Public policy must decide where these resources would produce the greatest benefits.

Problems of controlling water pollution are complicated by other factors. First, the level of benefits provided by removal of pollutants from a particular water basin depends on the potential uses of that basin. Where potential recreational uses are important, for instance, the benefits of removing pollutants are likely to be higher than in a major shipping channel. Final water quality standards should reflect the benefits attainable; controls on pollutant emissions can then be aimed at the achievement of those standards. Second, our knowledge about the effect on water quality of removal of different amounts of given pollutants is still incomplete. Even if final water quality goals can be appropriately established, the extent to which emissions of a
given pollutant need to be reduced in order to reach that quality level is not clearly known. A third problem is presented by the fact that pollutants result from both “point sources” (municipal and industrial waste facilities) and “general sources” (fields, farms, or mines) while controls generally have been enforceable only at point sources. There are instances in which, even with the removal of all pollutants from point sources, desired water quality could not be achieved; there are other instances in which current levels of pollutant emissions produce no deleterious effects.

Since in practice both benefits and costs of pollution control vary from basin to basin, participation from the local, State and regional levels is appropriate in setting the goals for water quality.

A similar problem of estimating costs and benefits is posed by a system of charges to discourage the emission of pollutants. Here the choice explicitly requires assessing the value to the public of removing pollutants and setting a charge that reflects the dollars and cents value of these benefits. The Administration is considering a legislative proposal for a charge to be levied on sulfur oxide emissions. To fix a charge per pound of sulfur emitted means calculating the costs of abatement and the benefits accruing to natural beauty, vegetation, property, and health from reducing these emissions. The Environmental Protection Agency has made rudimentary estimates of the more readily measurable benefits and costs of reducing sulfur oxide that will provide a basis for setting the charge.

As a method of limiting pollution, emission charges—or effluent fees, as they are sometimes called—possess distinct advantages. For one thing they result in an efficient allocation of the resources devoted to pollution abatement. Because each source of pollution will reduce emissions to the point where the costs of doing so just equal the charge, those sources that can clean up a given proportion of their emissions at low costs will press their abatement activities farther than sources incurring higher costs. In contrast to what would happen if equal standards were applied to each source, a larger share of abatement activity will be undertaken by sources with low costs. Insofar as abatement costs differ from source to source, a charge would achieve a greater reduction in emissions for a given amount of labor and capital resources committed to pollution abatement than would be achieved by a uniform standard. Conversely, a given reduction in emissions can be achieved more economically by setting a charge rather than a standard.

Another advantage of emission charges lies in the information they generate. Disagreements frequently occur about the technological feasibility or the costs of meeting specific standards. Polluters argue that the standards either cannot be met or can be met only at heavy cost, while environmental advocates minimize the difficulties. An emission charge always makes it in the interest of polluters to reduce emissions as long as the cost of doing so is less than the charge. The charge will therefore reveal the reduction in emissions that is economical at a cost equal to the emission charge itself.
Since environmental regulation should always be carried out with as much knowledge as possible of costs and benefits, an emission charge can be a valuable tool in supplying information about actual costs. As more information becomes available, the charge can be adjusted to equate benefits and costs.

RESEARCH AND DEVELOPMENT

Investments in scientific knowledge and in its application to productive uses have become an important characteristic of the American economy. Benefits from the development and utilization of knowledge are many and varied. They are evident in improved health for millions of Americans as well as in our greater understanding of outer space. They include entirely new products that enhance the quality of life and new techniques that expand the productivity of the Nation's human and physical resources. While an accurate evaluation of those benefits that directly improve economic performance is difficult—to say nothing of the less tangible benefits—it is widely agreed that the group of activities called research and development (R&D) plays a central role in our economy. It has led to new products and industries; and it can contribute in important ways to solving today's complex economic and social problems.

Research and development has become a major economic activity. In recent years over $25 billion—nearly 3 percent of the Nation's total expenditures—has gone into R&D. Two-fifths of the expenditures for this purpose reported in 1971 were made by private profitmaking firms. The Federal Government paid for most of the remainder (Table 26).

**Table 26.—Distribution of funds for research and development, by funding source and performer, calendar year 1971**

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<th>Source or performer</th>
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<tr>
<td></td>
<td>Total</td>
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<tr>
<td>By funding source:</td>
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<td>Total</td>
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<td>Federal Government</td>
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<td>Universities and nonprofit institutions</td>
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<tr>
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<td>Industry</td>
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</table>

1 Based on $26.9 billion reported by performers of R&D. Funding and performing estimates for universities include $0.3 billion financed by State and local governments.

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

Source: National Science Foundation.
The Federal Government is itself an important performer (as well as funder) of research and development; in 1971 nearly 15 percent of all R&D was performed directly by Federal agencies. But the Federal Government’s influence on the R&D industry is even larger than its actual share of these activities might imply. Government policy influences the supply of scientific manpower; it also affects incentives for private investment through cost-sharing arrangements, tax policies, patent laws, and other legal mechanisms.

RATIONALE FOR GOVERNMENT INVOLVEMENT

Government is a large purchaser of goods and services, and many of the things it buys have a large R&D component. Defense equipment and the exploration of space are obvious examples. Government as the purchaser of such goods and services must also support whatever research and development is required for their production, either through direct Federal funding of the R&D or indirectly through the price it pays for the production of the final goods themselves. The bulk of Federal expenditures for R&D fall in this category; national defense and space alone accounted for 79 percent of R&D funding in fiscal 1971 (Table 27). Research and development done for these purposes have had applications in other fields. Therefore the amount of R&D supported for defense and space is relevant to the scale of appropriate Federal support for R&D in the private sector.

But Government has an appropriate role in R&D even when its results will not be incorporated in Government purchases, because private firms would underinvest in R&D for goods normally purchased by the private sector. Although an investment in R&D may produce benefits exceeding its costs from the viewpoint of society as a whole, a firm considering the investment may not be able to translate enough of these benefits into profits on its own products to justify the investment. This is because the knowledge which is the main product of R&D can usually be readily acquired by others who will compete away at least part of the benefits from the original developer. This is particularly true of basic research, where the output frequently occurs in the first instance not as a marketable product, but rather as an advance in basic knowledge that can subsequently be used in applied research and development by a wide and often unforeseeable range of firms.

One way to encourage more spending on R&D for private goods is, of course, by direct funding. When this approach is followed, it is sensible for Government’s share of total expenditures to be greatest for basic research and to decline at subsequent stages. The difference between social and private benefits is largest for basic research and diminishes when investments begin to provide returns that can be obtained through private markets. Increasingly it is recognized, however, that even at the developmental, demonstration, and diffusion stages of innovation, social benefits may exceed private benefits.
There are also indirect ways the Government can promote R&D investment for private goods. Public policy has long encouraged and rewarded innovation and the progress of science through patent laws which permit inventors to capture a larger portion of benefits than would otherwise be possible. Other legal mechanisms including those that deal with "trade secrets" also permit the entrepreneur to internalize benefits that otherwise would accrue outside his firm.

The difficulty of a firm undertaking its own R&D efforts may be especially great when the firm is small in relation to the scale required for efficient R&D efforts. In some cases this difficulty is overcome by the R&D activities of larger firms which supply machinery or materials to smaller firms, for example, by producers of farm machinery or seeds for farmers. In other cases there are firms and institutions that specialize in research and development as such. Also, firms may be able to share risks or pool their support of R&D through formal or informal consortia under today's legal and institutional arrangements. For example, in fragmented industries in which several such consortia are probable, joint R&D would not normally be considered a violation of the antitrust laws. On the other hand, joint efforts among leading firms in highly concentrated industries would normally be considered undesirable. In general, actions taken by private groups which lead to improved allocation of resources would not be in conflict with the antitrust laws; actions which lead to excessive market power would be.

It must be recognized that in some industries the small firm is the most effective institution for accomplishing R&D. This is perhaps the case most frequently at the early stages of development of a new technology. Large firms sometimes prove to be insufficiently flexible to adapt to rapidly advancing technological innovation. In other instances large, regulated firms facing relatively assured markets sometimes achieve only a slow pace of innovation. The benefits of innovation may be capturable, but the spur of competition is absent.

When private action or patent protection is not sufficient to achieve scale economies or capture external benefits, direct Government support for R&D may be appropriate. This would be especially true in an established industry with many small firms. Under such conditions an individual firm may have little incentive to undertake its own research or to participate in an ongoing venture in R&D conducted jointly by a group of other firms; it would have difficulty capturing the benefits of its own efforts, and the benefits of their efforts would probably be available without the firm's financial support. Federal support for agricultural research, for instance, started because individual farms were too small to undertake their own research and lacked the incentives and institutions to support joint arrangements.

While it is clear that Federal involvement is essential to prevent underinvestment in R&D, the optimal amount of this activity is much less clear. The
proper allocation of R&D among alternative activities presents a further problem. In theory, benefit-cost analysis can answer these questions, but in practice it is difficult to measure reliably either the aggregate benefits from R&D or the benefits from investing in particular projects. This is inherent in the conditions which lead to government intervention—benefits are often widely diffused in society and thus difficult to measure. Comprehensive analysis is further hindered because the transformation of research into new knowledge and of new knowledge into public and private innovations and workable technologies is not yet adequately understood. Until better analysis is available to show the benefits, costs, and processes associated with R&D, informed judgment will continue to be the major element in shaping public policy.

RECENT DEVELOPMENTS

Several recent developments have raised serious questions about the adequacy of this Nation's research and development program. Recognizing these developments, the President in 1971 directed the Domestic Affairs Council to undertake an intensive review of Federal policy in this field.

The most prominent development has been in total expenditures for research and development; they grew rapidly until about the mid-1960's but have recently been rising quite slowly. Indeed, if total outlays are adjusted for rising costs, “real” outlays for R&D have actually been declining since 1968. As a result, research and development amounted to a smaller percentage of GNP in 1971 than in any year since 1960.

Federal R&D spending, in real terms, declined at an annual rate of 4 percent between its 1967 peak and 1971 principally because of scheduled reductions in space exploration from $5 to $3 billion. Nonfederal spending continued to show a real increase through 1969 and then declined the past 2 years.

New Emphases

New national priorities have been reflected in substantial reallocations of Federal R&D expenditures (Table 27). All of the recent declines in total Federal outlays for R&D have been in national defense and space. National defense accounted for 86.5 percent of Federal R&D expenditures in 1960; during 1965 this proportion declined to 56.9 percent and remained near that level through 1971. The major growth in Federal support from 1961 to 1966 was in space research and technology, which by 1965 accounted for one-third of the total Federal R&D expenditures. Since 1966 space R&D has declined each year both in absolute terms and as a share of the total. Expenditures for R&D related to human resources (mainly in health and education) and economic affairs increased rapidly throughout the decade. Between 1965 and 1971 the share of the total devoted to these fields doubled; together they accounted for 18.6 percent of Federal R&D expenditures in 1971.
TABLE 27.—Distribution of Federal expenditures for research and development by major function, fiscal years 1960, 1965, and 1971

| Function                          | 1960     | 1965     | 1971  
|----------------------------------|----------|----------|-------
| Total                            | 100.0    | 100.0    | 100.0 |
| National defense                 | 86.5     | 56.9     | 57.7  |
| Space research and technology    | 4.7      | 33.0     | 21.6  |
| Human resources 2                | 5.0      | 6.3      | 13.0  |
| Natural resources and environment| 3.0      | 1.0      | 1.7   |
| Economic affairs 3                | 2.6      | 2.5      | 5.6   |
| Other 4                          | .1       | .1       | .3    |

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<thead>
<tr>
<th>Percentage distribution</th>
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1 Estimate.
2 Health; education, and manpower; income security; veterans benefits and services; and community development and housing.
3 Commerce and transportation; and agriculture and rural development.
4 International affairs and finance; and general government.

Note.—Detail will not necessarily add to totals because of rounding.
Source: National Science Foundation.

Unemployed Scientific Manpower

Declines in “real” research and development expenditures, especially the shift in Federal programs away from defense and space, and a slowing of general economic activity have increased unemployment among the Nation’s scientific workers. Statistics available on the extent of this unemployment indicate that nationally it is lower than overall unemployment; but it is clear that for certain skills and in certain localities unemployment has become a severe problem, especially in contrast to the tight supply situation only a few years ago. The amount of actual unemployment, however, would probably not indicate the full extent to which scientific personnel are underutilized, since some people are employed at jobs which do not fully use their technical skills.

International Developments

During the last decade the United States has devoted a larger share of its GNP to research and development than any other country and a larger portion of these dollars to basic research, the type that provides the greatest external benefits. Experience of recent years has demonstrated that the benefits of R&D go beyond the borders of the performing nation. Basic research findings from all parts of the world are generally available for all nations to use, and the same increasingly appears true for applied and developmental research efforts as well. This has become evident in the shortened period between the time a new product is introduced and the time it is replaced by newly developed competitive products.

These developments are in part a natural result of expanding national economies throughout the world and of improved networks of international communications. They also result partly from specific policies of some nations to import the findings of basic and applied research conducted elsewhere and to concentrate domestic efforts on developing and refining applications.
These and other trends in national and international R&D policies have implications for the international competitive position of U.S. exports, which have been concentrated in high-technology goods, dependent on R&D investments. The conditions which underlay this Nation's comparative advantage in such goods in the past no longer appear so prominent. Both the level and the mix of U.S. research and development have changed considerably in recent years. The level of all R&D as a percentage of GNP in the 1970's may remain below that of the 1960's. In many other industrial nations the reverse would appear likely. The nature of R&D activities will help determine tomorrow's comparative cost conditions and the patterns of world trade.

EXPANDED SUPPORT FOR R&D

The President's budget for fiscal 1973 proposes an increase in R&D funding of $1.4 billion, or 8 percent, above fiscal 1972. This increase should help reverse the recent declines in "real" Federal funding for all R&D activities. Federal support is being expanded in several critical areas: basic research; national security; and civilian R&D. In addition, the Administration is moving to improve the overall management of R&D to ensure an appropriate level, priority, and efficiency of effort.

The Budget calls for a 15 percent ($700 million) increase for civilian R&D. Over one-half of the increase will be directed toward six priority domestic objectives. New emphasis will be given to potentially fruitful developments in the fields of energy, environment, transportation, health, natural disasters and drugs. In addition, two experimental programs will be initiated to stimulate R&D investments and applications by private firms and non-federal institutions. One program will be administered by the National Bureau of Standards; the other program, to be administered by the National Science Foundation, will include efforts to help improve our understanding of the process of innovation and research application. A variety of approaches will be followed by both agencies including more joint activities among universities, industry and Government, demonstration of new technologies and encouragement for small, innovative R&D firms.

SURFACE FREIGHT TRANSPORTATION

The Federal Government has long been involved in regulation of the transportation sector. Railroad transportation was first regulated under the Interstate Commerce Act of 1887. Other modes later came under regulation—motor carriers in 1935 and certain inland and coastal water carriers in 1940. Economic and competitive conditions have changed considerably since regulation was initiated, but the changed conditions have not been adequately reflected in the regulations under which the Nation's surface freight carriers are required to perform.
One of the most significant and negative outcomes of regulation has been the fixing of transportation rates in relation to the value of service to shippers, rather than in relation to the costs of providing service. In the early years such value-of-service pricing was a form of price discrimination intended to benefit railroads which operated under conditions approximating monopoly. As competition from other transport modes grew, rail rates substantially above transportation costs for high-valued goods presented attractive competitive targets for motor and water carriers even though the railroads might have been the low-cost carrier of such freight. The process continues today, and as a consequence, the railroads are increasingly the carrier of low-value bulk commodities despite their comparative advantage as a long-haul carrier for general cargo. Through regulation, value-of-service pricing has been imposed on shippers, requiring them to pay rates for services in excess of the costs of those services. This leads to the provision of less transportation services than is desirable for society. In addition, transport pricing unrelated to the costs of providing efficient service causes mislocation of facilities for commerce and industry, which must adjust to existing transportation rate patterns.

Regulation of carriers has also led to waste of resources within a given mode. For example, the Interstate Commerce Commission (ICC) certificates, which grant motor carriers the privilege to operate, require these carriers to traverse fixed routes and to pick up and deliver only at particular points on those routes. Regulation thus artificially imposes on motor carriers the disadvantages which accrue naturally to rail and barge lines. Some motor carriers and regulated barge operators are further limited in the commodities they are permitted to carry. This limitation compounds the empty backhaul problem: That is, largely as a result of restrictions in their operating certificates, trucks from A may haul one or more commodities to B and return empty, while others from B haul goods to A but also return empty. Removal of such restrictions on competition among carriers and of impediments to efficiency can mean significant savings to the economy as a whole without cost to any sector.

The railroads, especially, have faced another problem due to regulation. They are required to continue operating branch lines when such lines are unprofitable, and sometimes even when revenues do not cover their out-of-pocket costs.

To the extent that regulation has given one mode or sector artificial advantages in particular markets, relaxation of regulation would lead to some adjustments among sectors. Improved resource allocation would mean the loss of such artificial advantages, but in some cases it would also benefit more than one carrier. Abandonment of uneconomic branch lines, for example, would benefit rail carriers and simultaneously provide new markets for motor carriers in accord with their comparative advantage in short-haul carriage. Other shifts of traffic in accord with the comparative advantage of each mode could be expected.
There are no significant economies of scale for motor carriers and most major rail lines appear to be of sufficient size to achieve scale economies under current conditions. Thus there is little danger that competition, once established, could not remain viable.

Even though many regulations were designed for the benefit of railroads, the financial position of these carriers is particularly weak, a fact that became especially clear in 1970 and 1971. Though there is no single, fully satisfactory indicator which summarizes the financial position of railroads, especially in comparison with other modes and industries, their return on investment provides some information, particularly in year-to-year comparisons. The return on stockholders’ equity for the Nation’s Class I rail carriers dropped from 3.1 percent in 1968 to 0.4 percent in 1970 (Table 28). In comparison, the figure for all manufacturing firms in 1970 was 9.3 percent, down from 12.1 percent in 1968. Barge carriers approximately matched the performance of all manufacturing firms while motor carriers had somewhat lower returns.

Table 28.—Return on stockholders' equity for Class I railroads, Class I motor carriers, Classes A and B inland and coastal water carriers and all manufacturing corporations; 1 1967–70

<table>
<thead>
<tr>
<th>Type of business</th>
<th>1967</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
</tr>
</thead>
<tbody>
<tr>
<td>Class I railroads</td>
<td>1.8</td>
<td>3.1</td>
<td>2.6</td>
<td>0.4</td>
</tr>
<tr>
<td>Class I motor carriers</td>
<td>9.2</td>
<td>12.9</td>
<td>9.8</td>
<td>7.2</td>
</tr>
<tr>
<td>Classes A and B inland and coastal water carriers</td>
<td>12.2</td>
<td>11.0</td>
<td>8.9</td>
<td>10.4</td>
</tr>
<tr>
<td>All manufacturing corporations</td>
<td>11.7</td>
<td>12.1</td>
<td>11.5</td>
<td>9.3</td>
</tr>
</tbody>
</table>

1 Profits after taxes as percent of stockholders’ equity.
2 Carriers with more than $5 million revenues.
3 Includes intercity motor carriers of property, with revenues of more than $200,000 in 1967-68 and more than $1 million in 1969-70.
4 Class A and B inland and coastal water carriers with more than $100,000 in revenues.

Note.—The figures for various carriers have been the subject of some controversy. They are stated here as reported to Interstate Commerce Commission.

Sources: Interstate Commerce Commission and Securities and Exchange Commission.

The Nation’s largest rail carrier, the Penn Central, filed for reorganization in 1970; several other railroads had done so earlier and some, including the Reading, followed in 1971. The physical plants of many railroads are in serious disrepair because their long-term low-earnings performance has led to deferral of maintenance and delay in the purchase of new equipment. Since railroads are the major long-haul freight carrier, their difficulties have adverse effects on the entire surface freight system.

Changes in the earnings performance of the railroads and other carriers cannot be attributed principally to the total volume of their traffic. While freight traffic during the last decade rose somewhat more slowly than total output in the economy, the volume nevertheless increased at an average rate of more than 3 percent annually from 1960 to 1970. Total surface freight traffic rose from 1,084 billion ton-miles in 1960 to 1,491 billion in 1970. The growth in traffic is shown for various modes in Table 29.
As suggested above, much of the problem in the surface freight transportation system can be traced to regulation itself. Selective deregulation offers opportunities to improve the efficiency of the industry and increase its ability to meet growing demand.

### Table 29.—Freight ton-miles shipped by type of carrier, selected years, 1960–70

<table>
<thead>
<tr>
<th>Year</th>
<th>Total I</th>
<th>Type of carrier</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>Billions of ton-miles</td>
<td>Rail</td>
</tr>
<tr>
<td>1960</td>
<td>1,084</td>
<td>579</td>
</tr>
<tr>
<td>1963</td>
<td>1,189</td>
<td>629</td>
</tr>
<tr>
<td>1967</td>
<td>1,401</td>
<td>731</td>
</tr>
<tr>
<td>1970</td>
<td>1,491</td>
<td>773</td>
</tr>
</tbody>
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<table>
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<tr>
<th>Number of ton-miles:</th>
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<tr>
<td>1960: 1,084</td>
</tr>
<tr>
<td>1963: 1,189</td>
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<tr>
<td>1967: 1,401</td>
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<td>1970: 1,491</td>
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<th>Percentage distribution:</th>
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<tbody>
<tr>
<td>1960: 100.0</td>
</tr>
<tr>
<td>1963: 100.0</td>
</tr>
<tr>
<td>1967: 100.0</td>
</tr>
<tr>
<td>1970: 100.0</td>
</tr>
</tbody>
</table>

1 Excludes pipelines, which carried 20 percent of all ton-miles shipped, and air cargo, which carried a minor portion of all ton-miles shipped.

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

Sources: Interstate Commerce Commission and Transportation Association of America.

### REGULATORY MODERNIZATION ACT OF 1971

In 1971 the Administration proposed a relaxation of regulation in surface freight transportation. The Transportation Regulatory Modernization Act of 1971 would institute a series of regulatory changes leading to a more competitive market and a stronger surface freight transportation industry.

One of the most significant features the Act proposes is the removal of conditions in the ICC operating certificates that serve to reduce efficiency or restrict competition. It would permit greater freedom for carriers to serve points intermediate to the terminals specified in the certificates, and permit removal of route-of-travel and commodity restrictions. Procedures for such removal are to be established by the ICC within 6 months following passage of the Act. Certificates for the entry of carriers into the industry (which would mainly affect motor carriers) could not be denied, as at present, on the basis of the impact of new entry on a particular carrier; instead decisions would have to be made in light of the impact on the total quantity and quality of service provided over the routes in question. These modified criteria would apply only to existing certificate holders during the first 2 years following passage of the Act. After that they would apply to all.

The proposed legislation also would specify a “zone of reasonableness” within which surface freight carriers would be able to price their services. Railroads, truck lines, and barge lines would not be permitted to charge prices below the variable cost of providing service. In the absence of “inter-
modal" competition, a maximum price limit would also be legislated, equal to 150 percent of fully allocated costs. For the first year, however, no rate change in excess of 20 percent would be allowed. In the second year the band would be widened to 40 percent; but in any case rate changes would be required to fall within the zone determined by the legislated minimum and maximum. (The Department of Transportation has recently outlined to the Civil Aeronautics Board a zone-of-reasonableness approach for domestic airline rates. The move has received strong support from several air carriers and from the Department of Justice. Approval of such a zone, if wide enough to encourage meaningful price experimentation, would help materially to meet the goals for improved airline regulation set forth in the 1971 Economic Report of the President.)

Under specific criteria in the legislation, railroads would be permitted to abandon more of their unprofitable branch lines than is currently allowed. Approximately 20 percent of the country's railroad track miles are now deemed to be used too infrequently to be profitable. Also carriers whose management would be given greater freedom in setting their rates and in modifying their services would become subject to legal constraints similar to those imposed on competing firms in other industries.

FACTORS AFFECTING THE TRANSITION

The continuing expansion in freight traffic augurs well for an orderly transition to a more efficient system following passage of the Act in substantially the form proposed. Gradual shifts in traffic among modes can be expected in accord with the comparative advantage of each. Average freight rates in trucking would be expected to show some reduction, but this would not come at the expense of the typical operator's profits or the wages of labor. Instead, it could flow from the orderly removal of inefficiencies that regulation has imposed on the industry in the past. Moreover, the adjustments that would be brought about by the proposed legislation would occur over a 2- to 4-year period in the context of rising demand for carriers' services and under provisions of the legislation specifically designed to ease the problem of transition.

While relaxed regulations would lead to greater efficiencies in trucking without requiring major new investment (partly because the Nation's interstate highway system is nearing completion), the same is not true for the railroads. To compensate for the years of deferred investment in new plant and equipment, the railroads will have to make large capital outlays. Once these are in place, railroads should be able to fulfill their role as an efficient and profitable component of our freight transportation network with average freight rates lower than they are today.

A number of proposals and developments will improve the situation of the railroads. The Transportation Assistance Act, also proposed by the Administration, provides new incentives for increasing railroad rolling stock through Equipment Trust Certificates and the modern scheduling and con-
control of rolling stock. An increasing earnings potential for the railroads is also possible from the resumption of a high level of general economic growth, the additional stimulus to rail traffic which will result from rates more closely in accord with costs, and, where it has been unprofitable, the removal of passenger traffic deficits from the private railroads. These steps will make it less difficult for the railroads to attract private capital.

Passage of the legislation proposed by the Administration would be a significant step toward a stronger and more efficient transportation system. The legislation to relax regulation is expected to yield annual savings to the economy of roughly $2 billion; this will be reflected in some rate reductions and should also result in improved earnings in financially distressed segments of the industry. On the other hand, failure to move forward or even excessive delay could mean continued unsatisfactory performance of this vital service in the economy and may lead to increasing direct involvement by the Federal Government accompanied by large subsidies.

RAIL PASSENGER SERVICE

In 1971 direct Federal action was taken on rail passenger traffic. Past regulation often required railroads to continue passenger transportation services over a long period even when it was uneconomic to do so. This resulted both in prolonged losses to railroads and in deterioration of the quality of equipment and service.

Passenger traffic from a number of railroads was transferred to an autonomous, quasi-governmental corporation known as “Amtrak.” Several actions were carried out by this corporation during its early months of operation. Some unprofitable lines were discontinued; a significant segment of activity was concentrated in a number of high-density and potentially profitable travel corridors; and new investments were made. However, the funds initially appropriated for Amtrak have proved to be inadequate for continued operation. It is still too early to judge the success of this initiative.

HEALTH AND MEDICAL CARE

Improvement in the health of the population has always been a concern of Government. This concern has recently been intensified by sharp increases in the demand for medical services and by rapidly rising costs in this sector.

In fiscal 1971 the Nation’s medical expenditures for all types of care were $75 billion. At $358 per person, this sum represents 7.4 percent of the gross national product. Five years ago medical expenditures amounted to just under 6 percent of GNP, or $212 per person. In part, of course, this dramatic increase during the past 5 years is due to price increases. The medical component of the consumer price index has risen much faster than the overall index. Even after adjusting for increases in the medical care price index, however, real resources spent on medical care increased faster than real GNP and grew at an annual rate of 4.3 percent per capita since 1966. In the
past fiscal year the growth rate of expenditures slowed down to 2.5 percent per capita in real terms. This represented less of a slackening than occurred in the per capita GNP in real terms.

Although improvement in the health of the population was clearly the ultimate goal of these expenditures, it is also true that the relation between good health and medical expenditures is less than direct. First, our medical dollars may not always be used effectively. Ideally, the preferences of consumers and capabilities of suppliers freely interact in the market to determine the price and amount of the commodity consumed; and this interaction leads to the use of resources that best contributes to the material well-being of people. In the case of medical care, however, distortions in this process occur because, on the demand side, consumers are not always able to judge the service, and, on the supply side, competition is often limited by restrictions on entry into medical practice and hospital services. Although these restrictions may have been intended to protect consumers, as a side effect they may also impede the efficient utilization of resources. In addition, the dominant position of nonprofit organizations in the market providing hospital services raises other questions about whether incentives to minimize costs are as great in medicine as in other parts of the economy.

Yet even great improvements in the market for medical care would not solve all health problems. Another important problem arises because good health is related to many factors in addition to medical care. Some of these factors are subject to an individual's control: diet, exercise, smoking, and consumption of alcohol. Other conditions, such as the amount of pollution in the air and water, depend rather on the actions of society as a whole. In addition, there are more elusive influences, like the tension generated by attitudes toward work and other circumstances of modern life. The importance of life styles and environment to health has become much more apparent in recent years.

To start to answer the general question of how we can best “produce” health, we must find a way of measuring changes in the level of health. What must be measured is the actual output—health—not simply such inputs as amounts of medicine consumed, days spent in hospitals, or the hours in consultation with doctors. While no comprehensive measures of the national health have been developed, and each existing measure has its limitations, such indicators as mortality rates and disability days have been widely used to trace changes over time and to compare localities. The relationships observed between these measures of health and other variables have revealed a number of paradoxes.

It was once assumed that rising incomes would lead to improved health, but this assumption is now open to question. Once an area or country reaches the level of income typical of the most economically advanced nations, the correlation between income and health is less clear cut. It seems quite possible that beyond this level any further increases in income may call into play environmental factors unfavorable to health, and these may counterbalance
the favorable effects of better medical care per se. For example, those States with the highest per capita income do not necessarily have the lowest mortality rates. Indeed, there appears to be a slight positive association between income and mortality rates, except for infant mortality, even though States with the highest per capita income also tend to have more abundant medical care whether measured by medical expenditures or by such indicators as the number of doctors per capita.

A comparison of the United States with other developed countries provides another illustration of the difficulty of understanding the complex relations between medical expenditures, income, and health (Table 30). Although the United States has the highest per capita income, as well as the highest per capita medical expenditures, we do not have the lowest mortality rates. Our record of life expectancy at age 10, particularly for males, is below the average of the 22 countries belonging to the Organization for Economic Cooperation and Development (OECD). However, our infant mortality rate and maternal mortality rate, while not the best, are better than the average. Similarly, the five OECD countries with the next highest per capita income (after the United States) do not consistently have the best mortality records, particularly with respect to male mortality.

These patterns are puzzling. Does the activity of earning higher wages itself produce tensions which have adverse effects on health? Or do hazards engendered by the style of life become more critical with higher incomes? These considerations suggest that much is still to be learned about the complex “technology” of producing health.

Table 30.—Measures of life expectancy and mortality in the United States and other countries in the Organization for Economic Cooperation and Development, various years, 1960–69

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<tbody>
<tr>
<td></td>
<td>Male</td>
<td>Female</td>
<td></td>
</tr>
<tr>
<td>OECD countries*</td>
<td>60.9</td>
<td>66.0</td>
<td>23.2</td>
</tr>
<tr>
<td>United States</td>
<td>58.7</td>
<td>65.7</td>
<td>20.8</td>
</tr>
<tr>
<td>White</td>
<td>59.4</td>
<td>66.4</td>
<td>18.4</td>
</tr>
<tr>
<td>Negro and other races</td>
<td>53.0</td>
<td>60.2</td>
<td>31.6</td>
</tr>
<tr>
<td>Five countries with highest per capita income after United States:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sweden</td>
<td>63.2</td>
<td>67.5</td>
<td>13.0</td>
</tr>
<tr>
<td>Canada</td>
<td>61.0</td>
<td>67.1</td>
<td>20.8</td>
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<tr>
<td>Switzerland</td>
<td>61.0</td>
<td>66.9</td>
<td>15.4</td>
</tr>
<tr>
<td>Denmark</td>
<td>62.4</td>
<td>66.7</td>
<td>14.8</td>
</tr>
<tr>
<td>France</td>
<td>59.7</td>
<td>67.0</td>
<td>16.4</td>
</tr>
</tbody>
</table>

1 Latest data for the countries vary from 1960 to 1969.
2 For countries without data for the given year, data for the closest year were substituted.
3 Deaths under 1 year of age per 1,000 live births; excludes stillbirths.
4 Deaths per 100,000 live births.
5 Unweighted mean.
6 Excludes Luxembourg and Turkey.
7 Excludes Turkey.
8 Excludes Iceland, Luxembourg, Turkey, and Yugoslavia.

Furthermore, the health indexes that have been mentioned here cannot by themselves be used to evaluate the effectiveness of medical care. When the probability of becoming ill varies among States and countries because environmental factors, life styles, and even genetic characteristics differ, it can be misleading to base conclusions about the quality of medical care on simple comparisons between medical expenditures and measures of general health.

Since medical care is likely to remain a major instrument for improving the Nation's health, and since it is a focal point for public policy, there is a clear need for developing tests for the effectiveness of medical care. At present, we do not have the data required to make such tests, and thus we can evaluate only imperfectly the efficacy of alternative medical care policies.

TRENDS IN HEALTH INDICATORS IN THE UNITED STATES

Within the United States, trends in many of the health indicators have shown continuing improvement during the past 20 years. Infant mortality rates, which had declined very slowly—15 percent from 1950 to 1965—dropped 20 percent from 1965 to 1970. The number of restricted activity days, which is one measure of morbidity, has declined from an annual 16.2 days per person in 1960 to 14.8 days in 1968. Mortality rates for females over 54 years of age have declined since 1960. On the other hand, mortality rates for both male and female adults in the 25- to 54-year-age range and for males over 54 years of age have changed little. The lack of improvement in the mortality record of this latter group, despite the large increase in medical expenditures, is particularly puzzling.

One problem that the health indicators point up sharply is the difference in the health of different segments of the population, particularly the differences observed between the white and Negro populations in the United States. Although Negro mortality rates have declined considerably over the past two decades, they still remain much above the rates for the white population. Life expectancy for Negro males and females was about 7.4 years less than for white males and females in 1968. Despite a decline of 22 percent in infant mortality from 1965 to 1970, the Negro rate at 31.4 per 1,000 live births in 1970 is still 80 percent higher than the white rate.

FINANCING MEDICAL CARE

The foregoing discussion suggests that public policy for improving health should focus on a complex approach, with provision of medical care as only one of many facets. We must therefore decide how to allocate our health dollars among the different routes to better health: medical care, medical research, and such programs as those to purify the air or improve nutrition. Even when the appropriate role of medical care has been delineated, however, one is left with other problems, such as how the care is delivered and financed.

One important influence on policy has been the growing consensus that access to medical care should not depend exclusively on an individual's level
of income. As a result, public financing of medical services has become an increasingly large part of total outlays in these services, growing from 26 percent in fiscal 1966 to 37.9 percent in fiscal 1971. The Federal component has grown even faster, from 13 percent in 1966, before Medicare was really underway, to 25 percent in 1971. Shifts have also taken place within the private sector. Whereas direct payments by users once accounted for the bulk of all private spending for medical care (86 percent in 1950), by fiscal 1971 only 58 percent came from this source. Private health insurance or payments by a third party have now replaced much of these user payments.

The element of risk complicates the financing of health because an individual's need for medical care is much more variable than is his need for other goods and services. Insurance against high-cost illness has been the answer for most people. Hospital expenses for some 80 percent of the civilian population (almost 84 percent of the population under 65 years of age) are covered by private health insurance. The proportion with coverage for surgical expenses is 78 percent. A substantial part, more than 70 percent, of the hospital expenses borne by the private sector are covered by health insurance.

Easy access to lower-cost group health insurance often depends on employment. It is therefore not surprising that many of the poor, especially those not in the labor force, do not have adequate private coverage. Medicare gives protection to most of the elderly. Medicaid provides additional protection for roughly 18 million of the aged, the blind, the disabled, and low-income families with children, but this protection is very uneven among the States. Moreover, many of those who are not so poor and who have some protection nevertheless lack sufficiently comprehensive benefits.

This uneven coverage, combined with the soaring costs of the past few years, has led to considerable discussion about new methods of financing medical care. The criteria most frequently mentioned are not necessarily compatible. First, many people believe that access to medical care should not be limited by a person's financial resources. At the same time, financing schemes should provide a mechanism for controlling costs and encouraging efficient resource use. But the more medical care is divorced from current ability to pay, the greater the role of payments by a third party; and when third party payments increase, incentives for patients and doctors to economize tend to diminish. Medical services use scarce resources; if they are to be efficiently allocated, benefits must be compared with costs. Experience with Medicaid and Medicare and the growth of other third party insurance have shown that all too often the most expensive treatment is undertaken without giving sufficient consideration to what the treatment would cost and what it would contribute to the cure of the illness compared to the costs and benefits of other treatments.

The development of health maintenance organizations (HMO's) has recently received attention as a possible solution. These organizations provide all-inclusive medical services for a fixed payment set in advance. Since an
organization which receives a fixed sum has some incentive to budget its resources wisely to meet the needs of its clients, this system offers the promise of encouraging a control of costs along with an efficient use of resources. For example, it would be in the interest of the organizations to pay stricter attention to the benefits and costs of increasing well-patient care and diagnostic services to prevent future illnesses or to guard against overuse of facilities. This leads, however, to another concern. Is it possible to ensure that HMO's give high quality service? If there were sufficient competition between them, and if enough choice were provided among various forms of health insurance plans, both the cost discipline and the quality of service could be safeguarded.

NATIONAL HEALTH INSURANCE PROPOSALS

In his health message of February 18, 1971, the President outlined a comprehensive program for improving the Nation's health and specifically taking steps to resolve many of the problems mentioned above. The problem of making adequate medical care more widely accessible is covered through two plans in the proposed National Health Insurance Act. First is the National Health Insurance Standards Act which would require that employers offer a basic health benefit package to employees and their families; under this plan over two-thirds of the cost would be contributed by the employer, with the remainder coming from the employee.

The second plan proposed, the Family Health Insurance Plan, is intended to meet the needs of low-income families headed by an adult who is not usually employed and who would therefore not be eligible for coverage under the National Health Insurance Standards Act. In contrast to the Standards Act, which would be privately financed, the Family Plan would be federally financed: The Government would pay 100 percent of the costs for families in the lowest income bracket (up to $3,000 annually for a family of four), and other families' premiums would be scaled to their incomes up to the eligibility limits for the program.

Both plans incorporate some features designed to improve efficiency in delivering health care and to encourage cost restraints. Requiring that insured persons pay part of the costs of the benefits they receive, by means of deductibles and payment-sharing provisions, would encourage more prudence in the use of services and discourage waste. With insurance expanded to cover visits to physicians' offices as well as hospital care, resources may be better allocated between the two kinds of service. As further protection for the public, the Administration has urged measures to regulate the private insurers. Consumers would be protected against insurer insolvency. In addition, annual audits would be required, and rates would be disapproved if they were found to be unreasonable. Another provision would require a State's approval of new capital investments. It is hoped that in this way unnecessary duplication of very advanced hospital equipment can be avoided. Other provisions are designed to assist the consumer by requiring that both insurers and medical care providers disclose certain kinds of information.
One important effect of the two plans would be the impetus they would offer to the formation of HMO's. Both the National Health Insurance Standards Act and the Family Health Insurance Plan require that the option to join an HMO be provided as an alternative to health insurance. At present many States have legal barriers that prohibit the formation of HMO's. Federal legislation would preempt these barriers and allow HMO's to compete with traditional fee-for-service medical care. The rapid formation of these groups would be further encouraged by proposed Federal grants and loans. As this relatively new form of health care organization grows, it is possible that the competition thereby introduced will encourage experimentation with as yet undiscovered modes of delivery of health care.

Other parts of the Administration's proposals for an overall health strategy include pollution control, safety programs to reduce highway accidents and product hazards, and programs to improve nutrition through financial aid to the poor and better information for all. In addition, inspection and research efforts to control harmful food and drugs will be intensified. Research against sickle cell anemia has been intensified, and the President has signed the National Cancer Act of 1971 which provides for strengthened efforts in cancer research.

The Administration has also made a major commitment to solving our health manpower problems. The Comprehensive Health Manpower Training Act of 1971 and the Nurse Training Act of 1971 authorize institutional grants on a per student basis—a sizable incentive to medical and other health profession schools to train additional health personnel. Problems will, however, remain. For example, even with more and more physicians the problems of assuring an effective distribution of qualified doctors by geographical areas and specialties must still be solved. The 1971 Act provides incentives for physicians to practice in localities having a shortage of doctors as well as incentives for them to devote their time to primary care (particularly family medicine), a specialty which has been neglected in recent years.
CHAPTER 5

The United States and the World Economy

For the international economy, 1971 was a year of transition between two eras.

The monetary arrangements under which the free world operated after World War II had become subject, especially from 1965 onward, to increasing strains and frequent crises. In 1971 the system reached a critical turning point when the pressures of disequilibrium converged on its key element—the United States dollar. The suspension of the dollar's convertibility into gold and other reserve assets on August 15, 1971, marked the end of the old order and initiated the reforms required to correct the basic disequilibrium from which it suffered.

Exchange Rate Realignment

One major change that has already taken place is a significant multilateral realignment of exchange rates. This was achieved through a combination of market forces (floating rates) and negotiation; the process culminated in the Smithsonian Agreement of December 18. The United States agreed that a suitable means for devaluing the dollar in terms of gold to $38.00 per ounce will be proposed to Congress as soon as a related set of short-term trade expansion measures is available for congressional scrutiny. Upon passage of the required legislative authority, the United States will propose the corresponding new par value of the dollar to the International Monetary Fund (IMF). Other countries, notably Japan, Switzerland, and West Germany, agreed to revalue their currencies in terms of gold, while France and the United Kingdom agreed to hold to their previous par values.

The set of exchange rates negotiated in the Smithsonian Agreement is designed to help correct the relative overvaluation of the U.S. dollar. At the same time the new structure embodies exchange rates among all major currencies which should reduce payments imbalances between each of the major countries and all the others.

The revaluation of each of the major exchange rates against the dollar relative to the parities which prevailed on January 1, 1971, is shown in Table 31.

Wider Bands

The Smithsonian Agreement also embodied a second important change. Under the IMF Articles of Agreement, each member was required to
TABLE 31.—Changes in exchange rates of major currencies against the dollar, January 1, 1971 to December 31, 1971

<table>
<thead>
<tr>
<th>Currency</th>
<th>Percentage increase 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>Japanese yen</td>
<td>16.88</td>
</tr>
<tr>
<td>Swiss franc</td>
<td>13.88</td>
</tr>
<tr>
<td>West German mark</td>
<td>13.58</td>
</tr>
<tr>
<td>Netherlands guilder</td>
<td>11.57</td>
</tr>
<tr>
<td>Belgian franc</td>
<td>11.57</td>
</tr>
<tr>
<td>French franc</td>
<td>8.57</td>
</tr>
<tr>
<td>United Kingdom pound</td>
<td>8.57</td>
</tr>
<tr>
<td>Swedish krona</td>
<td>7.49</td>
</tr>
<tr>
<td>Italian lira</td>
<td>7.48</td>
</tr>
<tr>
<td>Canadian dollar</td>
<td>(T)</td>
</tr>
</tbody>
</table>

1 "Central value" of currency relative to January 1 dollar parity rate.

2 Canada has announced that it will continue to allow the Canadian dollar to float. The value of the Canadian dollar on December 31, 1971 (99.79 U.S. cents) was 7.9 percent greater than the pre-May 1970 par value (92.5 U.S. cents).

Sources: Treasury Department and International Monetary Fund.

maintain the exchange value of its currency against gold or the U.S. dollar within a band or range no wider than 1.00 percent on each side of its parity value. It was agreed, pending longer-term monetary reforms, that this band could be widened to 2.25 percent on each side by countries choosing to do so.

Trade Barriers and Mutual Security Costs

Outside the monetary sphere, the United States received commitments from its principal trading partners and allies to negotiate on measures designed to improve the access of U.S. exports to foreign markets and to increase their mutual security expenditures.

A New Monetary System

Beyond the immediate changes discussed or settled in 1971 the world faces the more extended task of designing a new order for international monetary exchange and cooperation. Although the dimensions of this new order have not yet been defined, it is clear that they will embody fundamental changes from the order under which the free world operated in the quarter century between 1945 and 1970. In particular, both the role of the United States within the international system as a whole and the role of the U.S. dollar within the monetary sector of the international system will have to be redefined in ways consonant with future realities rather than with those prevailing in the past.

The sequence of events that led to the suspension of dollar convertibility on August 15 is rooted in arrangements developed 25 years ago. Similarly the events begun on August 15, 1971, will have consequences that reach far into the future.

THE RECOGNITION OF DISEQUILIBRIUM

The decision by the United States to close the gold window and to impose a temporary 10-percent surcharge on imports, on August 15, divides
1971 into two parts. Any analysis of the year must key itself to this division.

During the first half of 1971 the exchange markets became progressively unsettled, and there was a massive flow of dollars which finally precipitated the August decisions. What caused so many more individuals, firms, and governments to become convinced so quickly that the value of the U.S. dollar was going to fall relative to the other major currencies? Why did this conviction develop after the apparently tranquil year which international finance experienced in 1970?

The swing of opinion was not triggered by any single event: Rather, it was built up through the cumulation of successive and mutually reinforcing layers of evidence and analysis. At least three tributaries of opinion about the position of the dollar converged in 1971. Together they contributed to speculation against the dollar on a massive scale.

1. One view was that the external monetary position of the United States had been in fundamental disequilibrium throughout the 1960's. A fundamental, or long-run, disequilibrium exists when the supply of a national currency to foreigners through the net balance of a nation's payments and receipts consistently exceeds the potential foreign demand for it. With the exchange rates and trading conditions that prevailed in the 1960's the United States was unable to finance its entire set of external policy commitments—on mutual security, on trade, on development aid, on capital mobility—except through the steady issuance of liquid dollar obligations. Balance could have been restored by a shift in relative exchange rates. However there was considerable inertia in the system's mechanism for exchange rate adjustments, especially with respect to the dollar. The rules and practices of the system put almost no pressure on surplus nations to revalue. At the same time, given the dollar's role as the major reserve currency, there were strong inhibitions against a U.S. devaluation. Furthermore, until the establishment of Special Drawing Rights (SDR), which were first issued in 1970, there was no adequate source of growth in world reserves other than U.S. deficits. Such a situation permitted the U.S. liquidity deficits not only to continue but to grow.

Since this process was not regarded as sustainable, the conclusion of the argument was that the disequilibrium would have to be recognized explicitly and corrected sooner or later by a fall in the external exchange value of the dollar.

2. A second basis for concluding that the U.S. dollar was overvalued in 1971 was the belief that the poor wage-price-productivity performance of the U.S. economy between 1965 and 1969 relative to that of its trading partners had significantly lowered the competitiveness of U.S. goods both in home markets and abroad. According to this view, the persistent and sometimes large trade surpluses of the pre-1968 period could be expected to disappear, and the already large U.S. payments deficits would get larger. Such developments would lead inevitably to a correction via a relative
devaluation of the dollar. These beliefs were reinforced by the comparatively poor trade performance of the United States in 1970 and 1971.

In 1970 the United States was in a mild recession, whereas the economies of most of its major trading partners were operating close to capacity. Since the normal effect of a recession is to reduce imports and the normal effect of a boom is to increase imports, the situation in 1970 should have brought with it a large increase in net exports from the United States to the rest of the world. Net exports of goods did increase—from $0.7 billion in 1969 to $2.1 billion in 1970—but this increase was too small to be reassuring, especially when compared with the average trade surpluses of $2.8 billion from 1965 to 1969 and $5.4 billion during the 1960-64 period. On the contrary, the $2.1 billion trade surplus achieved in 1970 was regarded as an indication of relative weakness, a sign that the trade surplus of the United States would inevitably turn to a trade deficit as soon as the U.S. economy began to recover from its temporary 1970 recession. This is exactly what happened in 1971.

3. Finally, there was the belief that developments in the conduct of monetary policy here and abroad (and hence in relative short-term interest rates) would induce large outflows of short-term capital from the United States to Europe.

In the United States the recession of 1970 brought with it a fall in interest rates. As monetary policy was eased in order to help the recovery phase of the economic cycle, interest rates, especially money-market rates, fell even further. For example, the rate on 3-month Treasury bills, which had peaked at 7.9 percent in January 1970, and was 6.7 percent in June, declined to 3.3 percent in March 1971.

In Europe, where the economic cycle lagged that in the United States by about a year, there was a much smaller decline in money rates. In the United Kingdom, for example, the rate on 3-month Treasury bills, which was 6.9 percent in June 1970, was still 6.7 percent in March 1971. The 3-month interbank loan rate in Germany declined somewhat more, from 9.6 percent in June 1970 to 7.6 percent in March. The improvement in the liquidity of the U.S. banking system in 1970 had already induced a substantial return flow of short-term capital from the United States to Europe as U.S. banks repaid their borrowings from their branches abroad. The trend continued in the first quarter of 1971. The United States had been in heavy deficit in 1970 (on an official reserve transactions basis the deficit was nearly $10 billion); with the additional short-term flows the deficit in 1971 was expected to be intolerably high.

When adverse developments in trade and money flows actually did appear, all of the different reasons for believing that the external value of the U.S. dollar might change converged. Actions based on these exchange-rate anticipations led to two massive flows of dollars: One was a substantial net outflow of liquid funds from U.S. residents to residents of other countries; the other was a large conversion into other currencies of dollar funds held by banks and businesses abroad.
The size of the sales of dollars to foreign central banks was reflected in the size of the U.S. deficit measured on an official reserve transactions basis. The deficit for the first quarter of 1971 was $4.7 billion (quarterly rate, not seasonally adjusted). Excluding the receipt in that quarter of Special Drawing Rights in the amount of $717 million, the deficit for the first quarter alone was $5.4 billion—a larger amount than in any full year except 1970. The quarterly deficit increased to $6.5 billion in the second quarter and to $12.7 billion in the third. By the end of September, the total deficit for the preceding 9 months reached $24.6 billion, which is equivalent to $31.9 billion at a seasonally adjusted annual rate (excluding the SDR allocation).

**REACTIONS TO THE U.S. DEFICIT**

The effect of the massive outflow of dollars on the official reserve positions of the major industrial nations—known as the Group of Ten—is shown in Table 32.*

<table>
<thead>
<tr>
<th>Table 32.—Official reserves, by country, 1968-71 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>[Billions of dollars; end of period]</td>
</tr>
<tr>
<td>United States</td>
</tr>
<tr>
<td>United Kingdom</td>
</tr>
<tr>
<td>Belgium</td>
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<tr>
<td>France</td>
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<tr>
<td>Italy</td>
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<tr>
<td>Netherlands</td>
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<tr>
<td>West Germany</td>
</tr>
<tr>
<td>Canada</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Sweden</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
</tbody>
</table>

* Includes $3.4 billion SDR allocated on January 1, 1970 and $2.9 billion allocated on January 1, 1971. The U.S. share in these allocations was $867 million and $717 million respectively.

Source: International Monetary Fund.

The recent large increases in these reserve positions began in 1970 but were not viewed as a problem in that year. Many European central banks, and notably West Germany's, had lost reserves during the previous year when the flow of short-term funds was away from Europe and into the United States. They and the Bank of Japan (whose reserves had previously been low relative to its volume of trade) were not unhappy to see their reserve positions increase. The continuing inflow of dollars into Europe, however, became a serious problem when the U.S. deficit widened in early 1971.

* The Group of Ten—or G-10, as it is called—originated in 1962 when these 10 members of the IMF agreed, through the General Arrangements to Borrow, to lend the IMF specified amounts of their currencies if a need should arise. Switzerland, which is not a member of the IMF, participates in the Group of Ten as an observer.
The U.S. monetary authorities took various actions designed to reduce or intercept the flow of short-term capital. The Export-Import Bank and the Treasury issued $3 billion of securities to foreign branches of U.S. banks, and thus intercepted funds that might have otherwise landed in foreign central banks. Steps were also taken in Europe to discourage the dollar inflow.

During 1970 West Germany had been the major recipient of the dollar outflow. This came about not only because of the general strength of the German economy and its large trade surplus but also because of the severely restrictive credit policy that West Germany was following, which kept effective interest rates in that country well above international levels.

As early as February 1971, the West German authorities tried to discourage further short-term inflows by eliminating the main factor which was attracting these inflows—the higher effective dollar-equivalent short-term interest rate available in West Germany. Because West Germany's domestic situation required a policy of tight credit and high interest rates, the authorities were not prepared to lower domestic interest rates to prevailing international levels. They tried therefore to achieve their objective by driving down the forward value of the mark by selling marks, for forward delivery, against the dollar. The operation proved to be unsustainable and was abandoned. The basic dilemma remained: How, in the face of large potential dollar inflows, could authorities simultaneously (1) continue the policy of credit restraint, (2) avoid exchange controls, and (3) maintain the parity of the mark?

In early May reports by leading German institutes of economic research highlighted the dilemma and recommended that the best solution was either for the mark to be revalued to a new parity, or for the market value of the mark to be freed from its parity value and allowed to float upward.

This recommendation was greeted with sympathy by some senior members of the German government, and the market became more convinced than before that the mark was about to appreciate relative to the dollar. Speculative funds, poised as they were for action, flooded into the German Central Bank at unprecedented rates in the early days of May. On May 5 the rate of inflow rose to $1 billion in the first 40 minutes of trading. The Central Bank stopped buying and let the dollar value of the mark rise under market pressure.

Other nations had to face the prospect that, as pressures on Germany eased with the rise in the mark-dollar rate, some of these speculative pressures would converge on their currencies. The "strong currencies" that were particularly vulnerable were the Dutch guilder, the Swiss franc, the Austrian schilling, and the Belgian franc.

The Netherlands permitted the guilder to float. Belgium, which had two exchange rates—one official and one "financial"—permitted the latter to appreciate. Switzerland and Austria responded in more orthodox fashion. During the weekend after May 5 they raised their parities by 7.07 and 5.05 percent respectively.
The subsequent rise that took place in the dollar value of the floating mark and guilder reinforced convictions that the U.S. dollar was fundamentally weak, not just against one or two currencies, but against virtually all the major trading currencies.

During the second quarter of 1971 the U.S. performance on trade and payments deteriorated further. With increasing evidence of this deterioration appearing in current reports, confidence in the sustainability of the dollar's exchange value fell further.

Demand by foreign central banks on the U.S. Treasury to convert a portion of the dollars they were absorbing was restrained by the knowledge that such a move would be self-defeating if everybody tried it at the same time. The stock of reserve assets held by the United States (around $14.5 billion) was far smaller than the stock of dollars held abroad. Nonetheless, there were substantial reductions in U.S. reserve assets. From the beginning of 1971 to mid-August the U.S. Treasury paid out over $3 billion in reserve assets—about 40 percent of this in early August. This depletion took place in spite of heavy temporary drawings of foreign currencies by the Federal Reserve (under its swap lines of credit with other central banks), which it used to absorb some dollars that central banks might otherwise have presented at the U.S. Treasury for conversion into gold or other reserve assets.

By August the private and public pressures to convert the dollar into other assets—foreign currencies and ultimately reserve assets or their equivalent—became overwhelming. The United States suspended convertibility of the dollar on August 15. Its value in terms of several major currencies started to float.

**AUGUST 15**

The President's announcement suspending the convertibility of the dollar included other measures to protect the Nation's trade and payments position. In particular, it imposed “an additional tax of 10 percent on goods imported into the United States.” As related measures, the President ordered a 10-percent cut in foreign aid and pointed out that the time had come for other nations “to bear their fair share of the burden of defending freedom around the world.” The tax applied only to goods on which duties had been reduced under reciprocal trade agreements, and in no case did it raise a duty beyond the statutory rate. Where it was limited by the statutory ceiling the surcharge was less than 10 percent. On automobiles, in particular, the tax amounted only to 6.5 percent. Furthermore, all imports subject to mandatory quantitative restrictions were exempt from the new tax. Such goods included petroleum, sugar, meat and dairy products, certain other agricultural products, and cotton textiles covered by the Long-Term Textile Agreement. The surcharge affected about one-half of U.S. imports.

In addition, subsequent statements of policy confined the Job Development Tax Credit proposed in the announcement to domestically produced
new machinery and equipment as long as the import surcharge remained in effect.

These actions, and the position taken by the United States in subsequent negotiations, linked the questions of improved access to foreign markets for U.S. exports and a better sharing of the financial burdens of mutual security to the basic issue of exchange-rate realignment.

The issue of exchange-rate realignment immediately raised some fundamental questions.

1. How should realignment be achieved? Should it be done through market forces (freely floating rates) or through negotiations?

2. If the realignment were to be arranged through negotiations, how large an improvement in the U.S. balance would be required? How should the counterpart of this improvement be shared among other nations? And, finally, what set of changes in exchange rates would this require?

Starting in September, the United States pursued both approaches to realignment. The second required an explicit analysis of the U.S. balance of payments.

**BALANCE-OF-PAYMENTS ANALYSIS**

Any analysis of the nature and size of U.S. external disequilibrium must begin with an examination of balance-of-payments accounts. These data, for the first 3 quarters of 1971 (at seasonally adjusted annual rates) and for earlier periods, are shown in Table 33.

The table is arranged to show several “balances” which summarize different aspects of our trading and financial relationships. Unfortunately, there is no single balance measure which adequately presents the total picture. In assessing the external accounts one must not only study the developments at the various levels shown on the table but also analyze these on the basis of evidence not contained in the table itself.

**BALANCE ON GOODS, SERVICES, AND REMITTANCES**

This balance reflects the flow of payments in these categories: Merchandise trade; services such as travel, transportation, and insurance; income on previous international investments; military expenditures involving foreign exchange; and Government pensions and private remittances. It excludes the flow of Government grants and of long-term and short-term capital.

The table indicates a steady deterioration in this measure of the U.S. position. During the first half of the 1960’s the United States had a favorable balance averaging $5.2 billion a year. But from the high point of $7.7 billion reached in 1964 the balance declined in each succeeding year except 1970. In the first 3 quarters of 1971 the balance was down to an annual rate of $0.1 billion—an adverse change of $7.6 billion since 1964.

The deteriorating trend in this measure largely reflected a parallel decline in our balance on merchandise trade. Like the balance on goods, services and remittances, the trade balance reached a high point in 1964 (when there was
TABLE 33.—U.S. balance of payments, 1960-71

<table>
<thead>
<tr>
<th>Type of transaction</th>
<th>1962-64 average</th>
<th>1965-69 average</th>
<th>1968</th>
<th>1969</th>
<th>1970</th>
<th>1971 first 3 quarters ¹</th>
</tr>
</thead>
<tbody>
<tr>
<td>Merchandise trade balance</td>
<td>5.4</td>
<td>2.8</td>
<td>0.6</td>
<td>0.7</td>
<td>2.1</td>
<td>-1.7</td>
</tr>
<tr>
<td>Exports</td>
<td>21.4</td>
<td>31.3</td>
<td>33.6</td>
<td>36.5</td>
<td>42.0</td>
<td>46.3</td>
</tr>
<tr>
<td>Imports</td>
<td>-16.2</td>
<td>-28.5</td>
<td>-33.0</td>
<td>-35.8</td>
<td>-38.9</td>
<td>-46.8</td>
</tr>
<tr>
<td>Military transactions, net.</td>
<td>-2.4</td>
<td>-2.9</td>
<td>-3.1</td>
<td>-3.3</td>
<td>-3.4</td>
<td>-2.7</td>
</tr>
<tr>
<td>Balance on investment income</td>
<td>3.9</td>
<td>5.8</td>
<td>6.2</td>
<td>6.0</td>
<td>6.2</td>
<td>7.5</td>
</tr>
<tr>
<td>U.S. investment abroad</td>
<td>5.1</td>
<td>8.6</td>
<td>9.2</td>
<td>10.5</td>
<td>11.4</td>
<td>12.0</td>
</tr>
<tr>
<td>Foreign investments in the United States</td>
<td>-1.2</td>
<td>-2.8</td>
<td>-3.0</td>
<td>-4.6</td>
<td>-5.2</td>
<td>-4.8</td>
</tr>
<tr>
<td>Balance on other services</td>
<td>-1.0</td>
<td>-1.2</td>
<td>-1.2</td>
<td>-1.3</td>
<td>-1.4</td>
<td>-1.4</td>
</tr>
<tr>
<td><strong>BALANCE ON GOODS AND SERVICES</strong></td>
<td>5.9</td>
<td>4.4</td>
<td>2.5</td>
<td>2.0</td>
<td>3.6</td>
<td>1.6</td>
</tr>
<tr>
<td>Private remittances and government pensions</td>
<td>-.7</td>
<td>1.1</td>
<td>-1.2</td>
<td>-1.3</td>
<td>-1.4</td>
<td>-1.4</td>
</tr>
<tr>
<td><strong>BALANCE ON GOODS, SERVICES, AND REMITTANCES</strong></td>
<td>5.2</td>
<td>3.3</td>
<td>1.3</td>
<td>.7</td>
<td>2.2</td>
<td>.1</td>
</tr>
<tr>
<td>Government grants ²</td>
<td>-.8</td>
<td>-1.8</td>
<td>-1.7</td>
<td>-1.6</td>
<td>-1.7</td>
<td>-1.9</td>
</tr>
<tr>
<td><strong>BALANCE ON CURRENT ACCOUNT</strong></td>
<td>3.3</td>
<td>1.5</td>
<td>-.4</td>
<td>-.9</td>
<td>.4</td>
<td>-1.8</td>
</tr>
<tr>
<td>Balance on direct private investments</td>
<td>-1.8</td>
<td>-3.0</td>
<td>-2.9</td>
<td>-2.4</td>
<td>-3.5</td>
<td>-5.9</td>
</tr>
<tr>
<td>U.S. direct investments abroad</td>
<td>-1.8</td>
<td>-3.3</td>
<td>-3.2</td>
<td>-3.3</td>
<td>-4.4</td>
<td>-5.5</td>
</tr>
<tr>
<td>Foreign direct investments in the United States</td>
<td>.1</td>
<td>.3</td>
<td>.3</td>
<td>.8</td>
<td>1.0</td>
<td>-.3</td>
</tr>
<tr>
<td>Balance on other long-term capital flows ³</td>
<td>-2.2</td>
<td>-6</td>
<td>1.9</td>
<td>.4</td>
<td>.9</td>
<td>-2.5</td>
</tr>
<tr>
<td><strong>BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL</strong></td>
<td>-.7</td>
<td>-2.2</td>
<td>-1.3</td>
<td>-2.9</td>
<td>-3.0</td>
<td>-10.2</td>
</tr>
<tr>
<td>Balance on nonliquid short-term private capital flows</td>
<td>-1.1</td>
<td>-2</td>
<td>.2</td>
<td>-.6</td>
<td>-.5</td>
<td>-2.6</td>
</tr>
<tr>
<td>Errors and unrecorded transactions</td>
<td>-1.0</td>
<td>-1.0</td>
<td>-.5</td>
<td>-2.6</td>
<td>-1.1</td>
<td>-11.4</td>
</tr>
<tr>
<td>Allocations of special drawing rights</td>
<td></td>
<td></td>
<td></td>
<td>.9</td>
<td></td>
<td>.7</td>
</tr>
<tr>
<td><strong>NET LIQUIDITY BALANCE</strong></td>
<td>-2.8</td>
<td>-3.4</td>
<td>-1.6</td>
<td>-6.1</td>
<td>-3.8</td>
<td>-23.4</td>
</tr>
<tr>
<td>Transactions in U.S. liquid short-term assets, net.</td>
<td>-.1</td>
<td>.1</td>
<td>-.6</td>
<td>.1</td>
<td>.2</td>
<td>-.1</td>
</tr>
<tr>
<td>Transactions in U.S. liquid liabilities to other than foreign official agencies, net.</td>
<td>.8</td>
<td>3.3</td>
<td>3.8</td>
<td>8.7</td>
<td>-6.2</td>
<td>-6.7</td>
</tr>
<tr>
<td><strong>OFFICIAL RESERVE TRANSACTIONS BALANCE</strong></td>
<td>-2.2</td>
<td>(.1)</td>
<td>1.6</td>
<td>2.7</td>
<td>-9.8</td>
<td>-31.2</td>
</tr>
<tr>
<td>Financed by change in:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>.1</td>
</tr>
<tr>
<td>Nonliquid U.S. Government and U.S. bank liabilities to foreign official agencies ⁴</td>
<td>.1</td>
<td>.7</td>
<td>2.3</td>
<td>-1.0</td>
<td>-.3</td>
<td>-7</td>
</tr>
<tr>
<td>Liquid liabilities to foreign official agencies</td>
<td>1.1</td>
<td>-.6</td>
<td>-3.1</td>
<td>-5</td>
<td>7.6</td>
<td>28.5</td>
</tr>
<tr>
<td>U.S. official reserve assets, net.</td>
<td>1.0</td>
<td>(.1)</td>
<td>-9</td>
<td>-1.2</td>
<td>2.5</td>
<td>9.4</td>
</tr>
</tbody>
</table>

¹ Average of the first 3 quarters at seasonally adjusted annual rates.
² Includes direct investment fees and royalties.
³ Excludes transfers under military grants.
⁴ Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.
⁵ Less than $0.05 billion.
⁶ Excludes U.S. Government nonliquid liabilities to foreign official agencies other than official reserve agencies.

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

Source: Department of Commerce.

a positive balance of $6.8 billion). After that it declined steadily until the rise in 1970. During the first 3 quarters of 1971 there was a deficit in the balance of trade at an annual rate of $1.7 billion. The adverse swing in the trade balance from 1964 to 1971 was $8.6 billion.

Underlying this trend was an extremely rapid increase in merchandise imports into the United States: From 1964 to 1971 imports rose by 147 percent, or at a compound rate of about 14 percent per annum. U.S. merchandise exports also rose dramatically—by 74 percent—but this increase
did not match the growth of imports. The persistently faster rise since 1964 in U.S. imports compared to U.S. exports was not caused by a relatively more rapid increase in the level of U.S. income and product. Indeed, measuring growth in terms of their gross national products, either real or nominal, all but one of our major trading partners were expanding at a faster rate than the United States. The demand aspects of this situation should have induced a more rapid rather than a slower rise in U.S. exports relative to U.S. imports.

**Price-Cost Developments**

There is no simple explanation for the decline in the U.S. trade surplus. One factor is that the relatively poor price-cost performance of the U.S. economy associated with the inflationary developments after 1965 reduced the relative competitiveness of American goods.

Table 34 gives two measures of the price competitiveness of U.S. products in the world economy. Neither measure is fully satisfactory. The index of unit labor costs in manufacturing is deficient for international comparisons because exports may have a product mix that differs from total production, and because measures of labor compensation in different countries do not equally reflect changes in total labor costs. Likewise, the index of unit values for exports of manufactured goods is sensitive to changes in the composition of exports and is subject to other technical deficiencies. Nonetheless, changes in these two indicators do offer evidence that price and cost developments between 1965 and 1969 were significant enough to influence the U.S. trade balance.

During the first half of the 1960's, price stability in the United States seems to have made U.S. goods more competitive in world markets. Unit labor costs in manufacturing fell in this country through 1964 while those in other industrial countries remained unchanged. The unit value of U.S. manufactured exports held its own relative to our competitors' export prices, neither of the indexes changing significantly. These price developments, together with the cyclical pattern of output changes in the United States and its markets, contributed to rising U.S. trade surpluses through 1964.

During the latter part of the 1960's, however, in a period of increasing inflation both in the United States and elsewhere, the price and cost competitiveness of U.S. products was eroded. From 1964 to 1969 unit labor costs in manufacturing rose at 2.5 percent per annum in the United States—more than twice as fast as the 1.2 percent per annum recorded for our major trading partners. Unit values of U.S. manufactured exports also increased more than twice as fast as those of our competitors.

In 1970 the relative price and cost position of the United States began to recover. This was partly the result of the earlier application of disinflationary policies in the United States than elsewhere and partly due to appreciations in the exchange-values of the West German mark and the Canadian dollar.
### TABLE 34.—Changes in U.S. relative cost and price position, 1961–71

<table>
<thead>
<tr>
<th>Cost or price and period</th>
<th>United States</th>
<th>Competitors 1</th>
<th>Ratio of U.S. to competitors 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>1964 = 100 3</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unit labor cost in manufacturing:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1961</td>
<td>103.4</td>
<td>98.9</td>
<td>104.6</td>
</tr>
<tr>
<td>1962</td>
<td>103.0</td>
<td>98.1</td>
<td>103.9</td>
</tr>
<tr>
<td>1963</td>
<td>101.4</td>
<td>100.4</td>
<td>101.0</td>
</tr>
<tr>
<td>1964</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1965</td>
<td>100.5</td>
<td>103.7</td>
<td>96.9</td>
</tr>
<tr>
<td>1966</td>
<td>102.2</td>
<td>105.9</td>
<td>96.5</td>
</tr>
<tr>
<td>1967</td>
<td>105.2</td>
<td>105.8</td>
<td>99.4</td>
</tr>
<tr>
<td>1968</td>
<td>109.2</td>
<td>104.3</td>
<td>104.7</td>
</tr>
<tr>
<td>1969</td>
<td>113.2</td>
<td>106.4</td>
<td>106.4</td>
</tr>
<tr>
<td>1970</td>
<td>116.9</td>
<td>116.0</td>
<td>100.8</td>
</tr>
<tr>
<td>1971, 1st half 4</td>
<td>120.3</td>
<td>122.7</td>
<td>98.0</td>
</tr>
<tr>
<td>Unit value of exports of manufactured goods:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1961</td>
<td>99.5</td>
<td>99.6</td>
<td>99.9</td>
</tr>
<tr>
<td>1962</td>
<td>99.5</td>
<td>98.3</td>
<td>101.2</td>
</tr>
<tr>
<td>1963</td>
<td>99.3</td>
<td>98.5</td>
<td>100.8</td>
</tr>
<tr>
<td>1964</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
<tr>
<td>1965</td>
<td>103.3</td>
<td>101.0</td>
<td>102.3</td>
</tr>
<tr>
<td>1966</td>
<td>106.2</td>
<td>102.7</td>
<td>103.4</td>
</tr>
<tr>
<td>1967</td>
<td>109.4</td>
<td>104.0</td>
<td>105.2</td>
</tr>
<tr>
<td>1968</td>
<td>111.9</td>
<td>103.9</td>
<td>107.9</td>
</tr>
<tr>
<td>1969</td>
<td>112.6</td>
<td>107.7</td>
<td>108.4</td>
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<tr>
<td>1970</td>
<td>122.8</td>
<td>114.9</td>
<td>106.9</td>
</tr>
<tr>
<td>1971, 1st half 4</td>
<td>126.7</td>
<td>117.7</td>
<td>107.6</td>
</tr>
</tbody>
</table>

1 Weighted average for Belgium, Canada, France, Germany, Italy, Japan, Netherlands, Sweden, and United Kingdom.
2 Ratio multiplied by 100.
3 Adjusted for changes in exchange rates.
4 Preliminary.

Sources: Department of Labor, International Monetary Fund, and Council of Economic Advisers.

In the first half of 1971, export prices of foreign manufactured goods, as measured by the index of export unit value, increased less than the corresponding index for the United States. But unit labor costs in manufacturing abroad were rising much more rapidly than here. Data for the year as a whole are not yet available. Both the U.S. program of wage-price restraint after August 15 and the revaluations of foreign exchange rates relative to the dollar will increase the relative price-competitive position of the United States significantly.

**CYCLICALLY ADJUSTED BALANCES**

The steady deterioration since 1964 in the U.S. balance of trade and current balance appeared to have been reversed in 1970. This was not a genuine reversal of the otherwise strong underlying downward trend. Rather, the cause was the conjunction of a recession in the United States with booming conditions abroad. In 1970, real gross national product fell in the United States; abroad, output continued to expand vigorously, although at a somewhat lower rate than that experienced in 1969. In short, the improvement of the U.S. current account balance in 1970 was a temporary phenomenon caused by the fact that cyclical influences operating in the United States were not in phase with those operating abroad.
The influence of such induced effects on the observed trade and current account balances can be eliminated by appropriate adjustments to provide a “cyclically adjusted” figure that better reflects the underlying position. Several agencies, including the Organization for Economic Cooperation and Development (OECD), the U.S. Treasury, and the Federal Reserve Board have begun to develop data on “cyclically adjusted” balances.

For 1970, the OECD’s cyclical adjustment estimates indicate that the observed U.S. surplus of $2.2 billion on current transactions (excluding Government grants) in that year was $2.4 billion higher than it would have been under “normal” conditions (defined as a condition of normal high employment in all OECD countries). U.S. calculations indicate a 1970 adjustment for cyclical and other special factors of $2.8 billion. According to the latter estimate, on an adjusted or normalized basis, the United States in 1970 had an unfavorable balance of $0.6 billion. Similarly, after adjustment, the underlying balance was much less favorable than is indicated by the observed figure of $0.1 billion for the first 3 quarters of 1971.

When allowance is made for cyclical factors, it becomes quite clear that during the past 7 years there was an uninterrupted deterioration of the U.S. position on current account (excluding Government grants): From a surplus (cyclically adjusted) of around $6.1 billion in 1965 to an estimated deficit (cyclically adjusted) of $2.5 or $3.0 billion for 1971. This is a significant swing in position even for an economy as large as that of the United States. The fact that the move was steadily in the same direction made the change all the more significant.

THE CAPITAL ACCOUNTS

The United States has been a net supplier of private and Government long-term capital and grants to the rest of the world in every year since World War II ended. A major component of the outflow of private capital is private direct investment abroad. This flow had grown from an average of $1.8 billion a year in the first half of the 1960’s to $3.3 billion in the second half of the decade. It reached $4.4 billion in 1970, and the annual rate was $5.5 billion in 1971. This net outflow has been substantially exceeded in every year of the decade by the income from U.S. direct investments abroad, which is included in the balance on goods and services.

There is a counterflow of foreign direct investment into the United States. Until 1968 this counterflow was very small, but in 1969 and 1970 it reached a rate of almost $1.0 billion a year. In 1971, the inflow of direct foreign investment into the United States not only ceased, but there were net capital transfers from foreign subsidiaries in the United States to their parent companies.

The other component of long-term capital flows in Table 33 shows the net result of numerous long-term capital inflows and outflows. It includes: Long-term U.S. Government loans (net of repayments received); U.S. purchases of foreign security issues; foreign purchases of U.S. securities; and long-term loan transactions here and abroad. For the 1960’s as a whole there was a
net outflow for this component. But beginning in 1968 an expansion occurred in the inflow of foreign long-term investment to the United States, including borrowing abroad by U.S. firms. In 1968 itself there was a net inflow, particularly from Europe. In 1970 the inflows balanced the outflows. However, in 1971 the inflows fell off, and outflows rose; as a result, the net outflow rose to a rate of $2.5 billion.

Taking the long-term capital account as a whole, net capital outflows rose by $4.9 billion between 1970 and 1971. Much of this adverse swing was caused by capital movements influenced by the prospect of speculative gains.

BALANCE ON CURRENT ACCOUNT AND LONG-TERM CAPITAL

The current account balance combined with the balance on long-term capital account plus Government grants provides an important yardstick (sometimes called the “basic balance”) for measuring and assessing the fundamental position of a nation relative to other countries. Starting in mid-1971 the official U.S. presentations of balance-of-payments data have begun to recognize the importance of this yardstick, and it is now published as a separate “balance.”

In 1970 the United States was in deficit on basic balance by $3.0 billion. Between 1970 and the first 3 quarters of 1971 the balance worsened by $7.1 billion to reach an annual rate of $10.2 billion. Of this, $2.2 billion was due to a worsening of the balance on current account and $4.9 billion to a net increase in the long-term capital outflow. Although the basic balance generally reflects underlying forces, it is sometimes subject to short-run movements. This appeared to be the case in 1971.

THE SIZE OF THE REQUIRED CORRECTION

Negotiations on exchange-rate realignments which began soon after August 15 required an answer to the question: By how much should the United States improve its basic balance in order to achieve a stable equilibrium? The U.S. representatives presented an analysis which showed that the required turnaround was about $13 billion. The calculations were as follows:

1. Under conditions of reasonably full employment both in the United States and in other major trading countries, the U.S. deficit on current account (excluding U.S. Government grants) for 1972 was projected to be $4 billion on the basis of the exchange rates and other trading conditions in effect in April 1971.
2. The annual outflow for Government grants and credits plus private long-term capital flows from the United States to countries other than Western European nations, Canada, and Japan was estimated at $6 billion, or just over one-half of 1 percent of the U.S. gross national product. The average annual outflow for these purposes during the 5-year period from 1967 through 1971 was about $5 1/2 billion.
3. A secure payments position would require that this estimated $6-billion capital outflow be covered by a surplus on current account. Since the projected “full-employment” current account for 1972 was in deficit by $4 bil-
lion, achieving a surplus of $6 billion required an improvement of $10 billion in the U.S. current account.

4. Two other factors caused additions to this basic estimate. The first was an allowance of $1 billion a year to cover a persistent outflow, which the data collection network does not capture. This outflow, which is shown as "errors and omissions" or unidentified transactions in the accounts, fluctuates from year to year, but it has been consistently negative since 1960, the average level being around $1 billion. The second factor was an allowance of $2 billion to provide the prospect of a small surplus on basic balance, to cover persistent short-term capital outflows or to serve as a margin of safety against errors in the underlying assumptions and calculations. With the addition of these two factors, the turnaround required for the United States to achieve a secure position was estimated to be $13 billion.

DEVELOPMENTS AFTER AUGUST 15

Reactions abroad to the August 15 announcement were varied. The major European exchange markets closed during the week following the announcement. When the exchange markets were reopened, no country except France attempted to hold the exchange value of its currency against the dollar within the 1-percent upper limit of its parity rate. The exchange value of the dollar in these markets declined, and on average continued to decline during the succeeding months.

In France the exchange market was segregated. For dollars received as a result of transactions related to international trade, the French government continued to intervene in order to support the parity rate. All other dollars received were diverted to a "financial franc" market; here, severe restrictions were imposed on inflows of funds, but the rate was allowed to find its own level.

In Japan the exchange markets were not closed after the August 15 announcement, and the Japanese government continued to intervene by purchasing dollars at the official ceiling rate. During August alone the Japanese Central Bank took in $4.4 billion—an amount considerably larger than their $2.9 billion of total dollar holdings at the end of 1970. Official intervention to hold the dollar rate at its ceiling was then suspended, and limited intervention allowed the value of the yen to rise about 5 percent relative to the dollar. In subsequent months the government continued to intervene in order to dampen the pace at which the yen would appreciate relative to the dollar. In the process, dollar holdings by the Japanese Central Bank increased an additional $1.4 billion to $11.6 billion by the end of October.

ALTERNATIVE ROUTES TO REALIGNMENT

Developments after August 15 made one fact clear: The immediate operational issue facing governments was a realignment of the pattern of
exchange rates, especially a realignment of the U.S. dollar relative to the other major currencies.

Among the questions associated with this operation were these:

1. How should the industrial nations arrive at a new set of equilibrium exchange rates? One route was to let all currencies float freely for a transitional period until a new set of equilibrium rates emerged. The other was to negotiate a multilateral shift to a new set of fixed rates.

2. If the second route was to be used, should the United States "contribute" to the realignment by a formal devaluation of the dollar against gold? Or should negotiations concentrate on exchange rates among currencies, expressed in dollars, with the question of the gold price being left to subsequent negotiations on longer-range issues?

3. How large was the readjustment required to restore the U.S. balance of payments to an equilibrium position? How large an average change in the dollar's exchange rate did this require? How should the effect of the proposed readjustment in the U.S. position be shared among other nations?

Mutually acceptable answers to all of these questions depended in part on related issues. The inclusion of trade practices and the question of mutual security costs as part of the overall negotiations involved other members of foreign governments besides financial officials. This affected the tempo and procedure as well as the substance of the negotiations.

REALIGNMENT THROUGH FLOATING

One issue was whether market-determined exchange rates or negotiations provided the most efficient route to equilibrium.

In spite of intervention by central banks, at first to hold rates within limits set by parity values, and later to suppress the pace of the relative appreciation of the currencies, a significant pattern of exchange-rate realignment did take place in 1971, particularly after dollar convertibility was suspended. The general path of these upward movements relative to previous parities against the U.S. dollar is shown in Chart 10.

The U.S. position on the issue was that a transitional period of free floating could lead the world swiftly and efficiently to a new pattern of equilibrium rates. This position was put forward by the Secretary of the Treasury on September 30, in his address to the Annual Meeting of the International Monetary Fund and World Bank, when he said:

... I believe we should welcome the help that the market itself can provide in reaching crucial decisions.

Many nations already are allowing their currencies temporarily to float, but they have done so with widely varying degrees of intervention and controls. As a result, some adjustments clearly needed are being delayed or thwarted, the process of multilateral decision-making impeded, and political questions multiplied. In this respect,
Chart 10

Foreign Exchange Rates

U.S. CENTS PER UNIT OF FOREIGN CURRENCY

WEST GERMAN MARK

NETHERLANDS GUILDER

SWISS FRANC

FRENCH FRANC

CANADIAN DOLLAR

ASTERISK INDICATES CENTRAL RATE ESTABLISHED DECEMBER 18, 1971.
SOURCE: FEDERAL RESERVE BANK OF NEW YORK.
our surcharge and restrictions on capital flows could, like those applied by other countries, themselves be a disturbing influence.

If other governments will make tangible progress toward dismantling specific barriers to trade over coming weeks and will be prepared to allow market realities freely to determine exchange rates for their currencies for a transitional period, we, for our part, would be prepared to remove the surcharge.

With few exceptions the suggestion of the United States was not accepted. In most countries market forces were suppressed by a variety of new measures, including regulation of inflows, exchange controls, and central bank intervention in the market. Eventually the question of realignment had to be settled through bilateral and multilateral negotiations.

The opposition to a policy of arriving at a new set of exchange rates via market-determined forces was motivated by a complex mixture of reasons.

RELUCTANCE TO REVALUE AGAINST THE DOLLAR

Many nations were reluctant to let their currencies appreciate too far against the dollar. This attitude was not, of course, an argument against floating as such; it applied equally well to revaluation via negotiation.

Raising the value of one's own currency (or permitting it to rise) reduces the price competitiveness of export industries. For many countries, expanding exports provided an impetus for overall economic expansion which these governments were reluctant to surrender. Even when governmental policies did not emphasize export expansion, the export industries were highly visible politically; governmental actions that might erode their prospects had to be taken with care. While revaluation also provided countervailing advantages to other segments of a revaluing economy—especially to consumers, importers, and tourists going abroad—these benefits tended to be spread more broadly and were therefore less visible. The reluctance of other countries to see their currencies appreciate relative to the dollar, regardless of how this was accomplished, was intensified in the second half of 1971 by the slowing of the boom conditions which had prevailed in many countries in prior years.

RELUCTANCE TO REVALUE AGAINST OTHER CURRENCIES

Reluctance to revalue against the dollar was one reason why many nations did not permit market pressures to express themselves freely. A collateral reason was the unwillingness to have the national currency revalued against other currencies whose values were being held down by intervention or controls. When one nation revalues relative to the dollar—which it may be willing to do in the interest of restoring equilibrium—it is thereby revalued relative to all other nations that do not revalue, and this it may not be willing to permit. Given the multilateral nature of the problem, the idea of floating toward a new equilibrium requires the cooperation of all nations. The absten-
tion of even one important nation from the joint action may be enough to hold up the entire process. This is what happened in the autumn of 1971.

The French commercial franc was held to its previous parity value against the dollar (established in 1969). When the West German mark moved up to a range of from 10 to 12 percent above its parity with the dollar (also established in 1969), it moved up to the same extent against the French franc. Since France is West Germany's largest trading partner, both for exports and imports, this 10 to 12 percent increase in the mark's cross-rate against the franc was regarded as unacceptable by West Germany, especially since this cross-rate had already been increased by nearly 23 percent in the 1969 realignments.

Similarly the unwillingness of the Japanese authorities to let the value of the yen rise freely relative to the dollar was affected not only by a desire to limit the change in the yen-dollar rate; it was also affected by the rates between the yen on the one hand and European currencies on the other.

### Reluctance to Correct by Revaluation Alone

There was a third set of motives for rejecting the floating route to realignment. This process of arriving at new rates would leave the dollar standing still in relation to gold while other currencies moved up by varying amounts. For one reason or another many nations were unwilling to accept such an outcome.

One of these reasons was that acceptance of the process would explicitly recognize the U.S. dollar as the benchmark against which all other national currencies set their values. There was a body of opinion in Europe that the benchmark should be an objective one, or at least a multinational one which did not bear the stamp of any single country. The existence of this body of opinion has important implications for the choice of a basic monetary unit of account in the international system of the future.

A second reason was that, if the United States devalued, other countries could reduce or avoid the political onus of revaluing. Thus it was easier for the United Kingdom, for example, to stand still for an 8-percent U.S. devaluation than to revalue by an equivalent amount with the United States standing still, even though the effect on exchange rates would be the same.

The third reason was that revaluation reduces the value, expressed in the domestic currency unit, of a nation's stock of foreign monetary assets. The value of its gold holdings measured in the national currency falls to the extent of revaluation, and so do its holdings of other reserve assets, notably the U.S. dollar. This balance-sheet loss for each revaluing nation, so far as the gold component is affected, could be reduced by requiring the United States itself to contribute to a realignment through an increase in the dollar price of gold.

The floating route was therefore rejected in favor of a negotiated pattern of change, in which the dollar itself made part of the adjustment by moving down relative to gold.
FINAL NEGOTIATIONS ON EXCHANGE RATE REALIGNMENT

By the end of November floating had moved exchange rates some distance from the old parities. The French commercial franc was the only major currency that was held to the upper limit of the narrow band around its parity value. Bilateral and multilateral negotiations between the United States and its principal trading partners on trade and mutual security costs had also commenced.

At the ministerial meetings of the Group of Ten nations held in Rome a hypothetical devaluation of the dollar against gold was discussed as one aspect of a possible overall package agreement (which included a pattern of currency revaluations by other nations and adjustments in existing impediments to trade). The United States offered to consider a new pattern of exchange rates involving an average adjustment that would not fully meet its objective of a turnaround of $13 billion.

The negotiations were completed on this basis at a later meeting of the ministers and governors of the Group of Ten nations held at the Smithsonian Institution in Washington on December 17–18. The key elements in the agreement were a new set of exchange rates and provisions for a wider band, within which market rates would be free to move up to 2.25 percent above or below the new “central rates.” As part of the agreement the United States lifted the temporary surcharge on imports which it had imposed on August 15.

The agreement will not be formally complete until Congress acts on the dollar price of gold. In the meantime, intensive trade negotiations have been in process with Canada, Japan, and the European Community. The results of these talks are to be available for congressional scrutiny when the gold price legislation is considered by the Congress.

The $35 per ounce gold price reflects the exercise of authority given to the President (in the “Thomas Amendment” of May 12, 1933) to redefine the gold content of the dollar at not less than 50 percent of its previous gold content. President Franklin D. Roosevelt, by Executive Order, set the price at $35 an ounce in 1934. The President’s power under the Thomas Amendment was extended periodically until it expired on June 30, 1943.

The par value of the U.S. dollar communicated to the International Monetary Fund in 1946 was 0.888671 grams of fine gold—equivalent to $35 an ounce. Under the terms of the Bretton Woods Agreements Act of 1945 (the Act which authorized U.S. membership in the International Monetary Fund), the President must obtain congressional authorization before proposing or agreeing to a change in the par value of the dollar.

INTERNATIONAL MONETARY REFORM

The Smithsonian Accord dealt with the most pressing issue which faced the international monetary system after August 15. It thereby set the stage for the more extended task of designing a new order for international monetary cooperation, on which more intensive work will begin in 1972.
Measured by overall results, the international economic arrangements in force since World War II were strikingly successful. The basic goals of the founders of the Bretton Woods system were achieved to a high degree. Trade and payments among nations were increasingly freed and grew rapidly. International consultation and cooperation developed to an extent previously unknown. The balance-of-payments problems which individual nations experienced at various times did not prevent the general pursuit of policies of relatively rapid and steady growth. In total, the record of the 25-year period was one of unprecedented progress for the world economy—and this is an impressive tribute to the functioning of the so-called Bretton Woods system.

At the same time, the way the monetary component of the system actually operated departed in many important respects from the mechanics envisaged by the participants at Bretton Woods. As reviewed in past Reports of this Council, a pronounced asymmetry developed between the role of the United States and the role of other countries. The stability of the system—its ability to reconcile trade, balance of payments, and reserve goals of various countries, to provide adequate liquidity, and to achieve elasticity in financing—came to be heavily dependent on the willingness and ability of the United States to lose reserves, to absorb more or less persistent deficits in its external accounts, and to maintain a passive role with respect to its own exchange rate. The dollar became the center of the system, and this placed particularly heavy responsibilities on the United States to maintain stability domestically along with open trading and financial markets.

The system which evolved had advantages and disadvantages from the standpoint of both the United States and other countries. Whatever its merits, the important underlying premises of a dollar-centered system are no longer valid. With the strong recovery of the European economies, with the striking growth of Japan, and with industrialization proceeding elsewhere in the world, the position of the United States in the world economy is no longer as predominant as it was in the 1950's. The development and extension of the European Community, with its plans for increasingly close economic and monetary integration of the region, adds an important new, if still uncertain, dimension to the picture. In monetary terms, the U.S. reserve position became inconsistent with a presumption of convertibility of the dollar into reserve assets. This was aggravated by the repercussions of domestic inflation since the mid-1960's, which weakened the U.S. trade and payments position.

Reform of the international monetary framework has been the subject of extensive discussion for many years. The creation in 1970 of a new international reserve asset, Special Drawing Rights, is a major innovation in the system. A thorough report by the Executive Directors of the International Monetary Fund on the role of exchange rates in the adjustment of international payments, also issued in 1970, both reflected and contributed to the growing consensus that there is a need for greater flexibility in official exchange rates.
In 1972 further and more far-reaching negotiations on restructuring the international monetary system will begin. Although the eventual shape of the new order will not be known until these negotiations are completed, the primary questions with which the negotiators must deal are clear.

1. One issue is the degree of "fixity" that should be provided for in the exchange rate mechanism. The Bretton Woods system contemplated that each IMF member government would establish a fixed par value for its currency and maintain this value in the exchange markets within a narrow margin of plus or minus 1 percent. The par value would be adjusted only when a fundamental disequilibrium became manifest over a period of time, and then presumably by a substantial amount. In practice, this rigidity, broken at intervals under heavy pressure, may have become self-defeating in terms of maintaining the broader stability and continuity of the system. Should the new system place an equal emphasis on exchange fixity by requiring all nations to establish official par values? If so, should the band of exchange rate variation permitted around par values be widened? Alternatively, under what conditions should countries be permitted to let exchange values of their currencies be determined by market forces, as Canada and others have found it convenient and useful to do in the past?

2. A second, related issue concerns the mechanisms to be utilized for maintaining reasonably balanced international payments positions. As indicated, the Bretton Woods system tended to think of an exchange rate change as an adjustment of last resort. Nations whose currencies became overvalued relative to other currencies have tended to delay unduly before making a change in the exchange rate. Furthermore, because nations with undervalued currencies also resisted exchange rate changes, and were able to do so longer, most exchange rate changes have been downward. The operating question is how changes might be made in a less disturbing way in the future, with pressure more evenly distributed among surplus and deficit countries, and with the United States having the same degree of freedom of action as other nations.

As noted, there is a growing consensus in favor of greater flexibility: However the correct degree of flexibility, the rules for implementing the process, and the role of the IMF in this implementation process need to be examined and defined.

The need for wider margins than the ±1 percent specified in the Fund’s Articles of Agreement is also well recognized. The Smithsonian Accord provides temporarily for margins of ±2½ percent. The proper width of margins for the longer run must be determined.

Negotiations on the future adjustment process will also cover issues other than exchange rate flexibility. These will include ways and means of influencing short-term capital movements and the degree to which the mix of monetary and fiscal policy should be influenced by external considerations.

3. A third issue is the question of how much liquidity the system needs and how this liquidity should be provided. The amount of liquidity needed
will depend on how the other questions are answered, including particularly the flexibility and efficiency of the adjustment mechanism. The question of how liquidity is to be provided raises the issue of the role of alternative reserve assets. The United States and many other countries share the conviction that gold should and will play a diminishing role in the system. Already, considerable progress has been made in developing the SDR as an alternative international reserve asset, but many questions remain, including the appropriate role of the dollar and other reserve currencies.

The agenda for negotiations is a large one. Fortunately, there is wide agreement that the objectives of the Bretton Woods system remain as valid as before and negotiations will be based on the fundamental premises that nations want to promote international monetary cooperation, balanced growth and increased freedom for trade and payments, stability in the exchange markets, and the avoidance of competitive undervaluation of rates. The challenge will be to find the mechanisms that will assure those results, taking into account the realities of the 1970's and the new balance of economic power and responsibilities.

**TRADE POLICY DEVELOPMENTS IN 1971**

For over three decades the free world has been gradually liberalizing commercial policy to achieve the economic and political benefits of an open trading world. The United States has taken a position of consistent leadership in this movement. This course recently has faced and survived two major tests. There have been strong pressures in the United States itself to redirect policy toward quantitative restrictions on trade and investment. While the United States extended import restraints to a few additional commodities in 1971, legislation that would apply quantitative restrictions broadly to imports has not been enacted. The second major test, and one that became subject to spirited debate in 1971, came with the trade policy actions to combat the U.S. payments deficit taken in connection with the New Economic Policy. Although it provoked considerable controversy, the import surcharge did not set off the series of retaliatory actions abroad that had been feared in some quarters. And it was removed before the end of 1971 when the currency realignment made it no longer necessary.

During a period when commercial policy is under major pressure for change—as it has been during the past 2 years—it is particularly important that necessary preoccupation with month-to-month events not be allowed to blur appreciation for the long-term objective of U.S. international economic policy. That objective is an open world economy in which trade and investment flows among countries are not distorted by national barriers to free exchange. Moving toward that objective will enhance broad foreign policy objectives for this country, and it will provide important economic benefits. International exchange permits mutually beneficial specialization in production among countries; it provides healthy competition to ensure efficiency in domestic industries; it expands the variety of goods available to U.S.
consumers and producers; and in times of inflation it provides a wholesome brake on price increases.

To many Americans the benefits of liberal trade policies are not highly visible because they are broadly diffused. But the short-run costs that trade liberalization sometimes imposes on specific groups are usually highly visible indeed. Thus, the costs of liberalization are more keenly felt than the benefits, and that tends to make removal of trade and investment restrictions difficult to achieve.

Substantial progress has nevertheless been made toward free international exchange in industrial goods during the past 25 years, mainly by reducing tariffs. But much work remains. The President anticipated the controversial and difficult policy issues confronting the United States when he appointed the Commission on International Trade and Investment Policy to study U.S. positions and to recommend a policy for the 1970's. He also recognized that proper formulation and implementation within the executive branch required better coordination among the agencies engaged in international economic policy. In early 1971 he established the Council on International Economic Policy in the White House.

The President's Commission on International Trade and Investment Policy, whose membership was drawn from business, labor, and the universities, presented its report in July, United States International Economic Policy in an Interdependent World.

The Commission's recommendations included, on the one hand, measures designed to strengthen the capacity of U.S. industry and labor to compete effectively and, on the other, proposals for negotiations with our major trading partners. Specifically recommended were actions which might reduce the adverse effects on U.S. exports of the European Community's Common Agricultural Policy and the Community's widening preferential tariff arrangements and international action to deal with market disruptions due to imports.

For the longer term, the Commission recommended negotiations "looking toward the progressive reduction and eventual elimination of barriers to trade and investment," including reform of the international monetary system, with negotiations eventually leading to the "elimination of all barriers to international trade and capital movements within 25 years."

The purpose of the newly organized Council on International Economic Policy is to strengthen the policymaking process. The Council is chaired by the President, and its members are the Secretaries of State, Treasury, Defense, Agriculture, Commerce, and Labor, the Ambassador at Large, the Director of the Office of Management and Budget, the Chairman of the Council of Economic Advisers, the Special Representative for Trade Negotiations, the Assistant to the President for National Security Affairs, and the Assistant to the President for Domestic Affairs. The President stated in his Executive Order that the Council was to (a) "achieve consistency between domestic and
foreign economic policy," (b) "provide a clear, top-level focus for the full range of economic policy issues," and (c) "maintain close coordination with basic foreign policy objectives." The work of the Council is directed by its Executive Director, who is also Assistant to the President for International Economic Affairs. As his first assignment, the Executive Director was instructed by the President to prepare a review of the position of the United States in a changing world economy. This briefing was presented to the Council in April 1971 and was subsequently reviewed with leaders in Congress and others outside the Administration. The Council is now pursuing work programs in a variety of areas—such as export promotion, more comprehensive adjustment assistance programs, and foreign investment policies—and is planning for a series of foreign economic negotiations.

In addition to strengthening its own apparatus for policy formulation in the trade sector, the Administration has extended contacts with our trading partners. The President's Special Trade Representative has participated in the High Level Trade Group assembled by the Organization for Economic Cooperation and Development to explore avenues for major negotiations which might lead in the next few years to a more effective climate for international trade and investment. This group began monthly meetings in November and aims to complete a report for the Council of the OECD in the spring of 1972.

The Commission's report and the coordinating work of the Council have helped to identify the major policy issues in the area of international trade and to initiate steps through which these issues will be resolved.

EXPORT POLICY

The disappearance of the traditional U.S. trade surplus in 1971 itself raised a fundamental question. Is a trade surplus desirable or essential for the United States?

On one side of this question is a view that exports should always exceed imports by a wide margin because net exports are both a stimulant to the domestic economy and a symbol of relative economic strength. This position views exports as inherently desirable and imports, unless unobtainable domestically, as undesirable or at least suspect. The policy prescription corresponding to this mercantilist position calls for adoption of the measures necessary to keep the volume of U.S. exports higher than the volume of imports in every single accounting period, regardless of cyclical circumstances or developments affecting other elements in the balance of payments.

In another corner are those who argue that after years of investment abroad the United States has achieved a special status in the world. It is a major creditor nation which receives a large and growing income from overseas investments. It is possible, indeed appropriate, for a nation in this position to use some of this income to finance a net inflow of imports. These net imports are the fruits of resources the Nation has foregone consuming or investing domestically in previous years.
In fact, however, the appropriate approach to exports depends upon the approach that is taken to all of the other elements in the balance of payments. While the United States is a major creditor nation—the inflow of net investment income was over $6 billion in 1970 and is expected to grow in the future—a large net investment income does not mean that the country can afford an equally large trade deficit. U.S. policies involve other major payments commitments—grants and loans to less developed countries, mutual security costs, pensions and remittances to citizens living abroad, and funds for additional overseas investments. To the extent that these commitments are desirable, as they clearly are, they also have to be financed. Given the probable size of these flows in the immediate years ahead, it is unlikely that net investment income will be large enough to cover them, to say nothing of a trade deficit as well. Thus a trade surplus will be required if our goal is external balance. Moreover, export growth will permit imports to expand.

For the long run the optimal policy toward exports, as well as toward imports, is one directed to achieving efficient resource allocation within a system of generally balanced international payments.

The preferred means of correcting any disequilibrium that might arise in a nation’s balance of payments is through a change in its exchange rate. This method, unlike other ways of restoring equilibrium, does not distort the relationships among transactions: All sellers and all buyers of foreign exchange are affected alike. A change in the exchange rate of the dollar was the process used by the United States in 1971 to correct its balance-of-payments deficit.

However, in a world where trade and investment flows are subject to either special impediments or incentives, more direct measures to stimulate exports may sometimes be justified. Legislation to authorize Domestic International Sales Corporations and steps to expand export credit facilities are examples of such measures.

**Domestic International Sales Corporations**

The provisions of American and foreign tax laws in many cases have provided an incentive for U.S. firms selling abroad to establish production facilities overseas. U.S. tax liability is not incurred on income earned abroad until it is repatriated, and effective foreign tax rates are often less than those in the United States. Exporters from domestic sources, on the other hand, face immediate tax liability.

This imbalance has been removed in part by the Revenue Act of 1971. Under provisions of the new law U.S. exporters will be able to enjoy tax treatment comparable to that of U.S. producers located abroad. The law provides for formation of a new type of corporation to be known as a Domestic International Sales Corporation (DISC). Taxes on 50 percent of a DISC’s income may be deferred indefinitely, provided that 95 percent of the DISC’s receipts and assets relate to qualified exports. Loans to a parent company to finance research and development expenditures, inventory accumulation, or investment in plant and equipment can be counted as export-related assets,
so long as the proportion which these loans bear to total expenditures for such purposes does not exceed the proportion of the borrower’s total sales accounted for by exports. Dividends to DISC stockholders are to be fully taxed.

The Administration’s 1971 proposal concerning DISC underwent two major changes in Congress. First, the 100-percent deferral originally requested by the Administration was reduced to 50 percent. Second, Congress added a proviso to discourage a DISC from investing tax deferred income in foreign production facilities. In the bill enacted, the tax deferral on any DISC profits which are lent to parent companies will be terminated if such profits are judged to have been invested in foreign plant and equipment.

The potential for tax deferral in a DISC is intended to provide U.S. exporters with tax advantages similar to various advantages provided exporters in other countries. The availability of DISC will also blunt one incentive that has existed for U.S. firms to locate production facilities abroad rather than at home.

**Export Credit Facilities**

The competitive position of sellers in different countries for third-country export markets is influenced by the export credit facilities they can offer, and many governments have taken measures to provide especially advantageous financing for exports. In the United States export credit facilities are influenced by general monetary policy, by various banking regulations, by the operations of the U.S. Export-Import Bank, and by policies of other governmental financing and procurement agencies. Apart from monetary and pricing policies which led to an easing of interest costs for all borrowers in 1971, two steps were taken which increased the special credit facilities for exporting.

On August 17 legislation was enacted to exempt export credits from the Voluntary Foreign Credit Restraint guidelines administered by the Board of Governors of the Federal Reserve System. The formula announced by the Board of Governors in November freed both bank and nonbank financial institutions to expand their lending for exports. It was also designed to remove some existing or potential inequities among the institutions participating in the program.

Legislation passed in August removed Export-Import Bank receipts and disbursements from Federal unified budget totals and provided new leeway for the Bank’s export financing activities. New short- and intermediate-term discount programs, together with activity under its other programs, should increase the Bank’s total authorizations for loans, guarantees, and insurance from $5.4 billion in fiscal 1971 to $11.5 billion in fiscal 1973.

**EASING THE ADJUSTMENT TO IMPORTS**

Changes in the volume and composition of a country’s imports usually reflect underlying changes in incomes, tastes, or comparative costs. The release of resources from industries that lose their competitiveness is offset by expansion in industries that become more competitive. The value of total
production is increased by the reallocation of resources to what have become more productive uses.

In some cases, however, imports increase so rapidly that they displace domestic resources faster than these can be transferred to other uses. Public policy cannot ignore such disruptions to individual markets or areas, particularly if there is general excess productive capacity and limited opportunities for resources to shift. Positive programs of adjustment assistance are then required to facilitate the necessary transfer of resources into other uses and to ease the financial stress on the workers and owners involved. The adjustments can also be moderated by controlling the pace at which imports are permitted to increase.

Moderation of imports through arrangements with the main suppliers is a technique that has been used for several years both here and abroad. U.S. steel imports are now subject to such agreements. Cotton textiles and certain meats have been for some time subject to intergovernmental agreements. Government agreements to limit the rate of growth of manmade and woolen fiber apparel and textiles were concluded in 1971.

Imports of textiles and apparel have long constituted a special problem for the United States. On the one hand, textiles have an important place in the budget of all Americans, and the benefits of low-cost imported products are widely shared. On the other hand, the 2.3 million persons employed in the textile and apparel industry in the United States tend to have characteristics that make adjustment to new employment especially difficult.

The rate of growth of cotton textile shipments to the United States came under regulation in the multilateral Long Term Arrangement on Cotton Textiles of 1962. Imports of yarns, fabrics, and apparel made of wool and manmade fibers, however, have continued to grow at a rapid rate. The volume of imports of manmade fiber textiles increased more than seven times between 1964 and 1970; and in the first 6 months of 1971 the flow increased almost 80 percent above the level of the corresponding period a year earlier.

After especially difficult negotiations, memoranda of understanding were signed in October with the governments of Japan, the Republic of China, Korea, and Hong Kong, the leading sources of supply. Under the terms of these memoranda, the parties agreed to limit their exports of manmade fiber and wool textiles to this country. The agreements limit the growth rates for various categories of these imports to levels in the range of 5 to 7.5 percent per annum. Such rates, while much lower than the growth rates recently experienced, still somewhat exceed the growth in the U.S. market. The agreements are intended, therefore, to provide time for the domestic industry to adjust, while still permitting American consumers increasingly to enjoy the benefits of low-cost imported supplies.

The use by the United States of voluntary agreements with foreign governments or private groups to restrain shipments to the U.S. market has some attractions over other forms of import restraint such as tariffs or import quotas. Tariffs and quotas are often subject to international treaties.
and agreements, and further resort to them may also require legislative action. Restraints that are built into law have often become permanent even when the original need for restraint was itself only a temporary one. In contrast, the technique of requesting foreign suppliers voluntarily to limit their sales in the United States is simpler and avoids the complications of law.

However, voluntary agreements also have serious disadvantages. While the limitation of foreign supplies in the U.S. market lifts domestic prices for the goods above what they would otherwise have been, thereby providing the intended relief to domestic sellers, the higher prices that American users pay in this instance are not offset through the higher government tax revenues that would have been collected had higher tariffs been used to achieve the same purpose. It is also not clear that voluntary agreements are always easy to remove. In order to make the restraints operative, suppliers need to coordinate their production and sales plans. In the past, export restraint mechanisms have frequently been used as instruments of monopoly power. Dissolving them has without exception been extraordinarily difficult. The fact that they originate now under duress from the buyers rather than from the volition of sellers may not in the end change their character.

There is a more fundamental danger in too widespread a use of the export restraint technique. This is the additional threat it poses to hopes for a world organized predominantly on free-enterprise principles. Market-oriented societies can be efficient and progressive when competitive forces are present to inhibit the exercise of arbitrary power. But competition requires nurture. Voluntary agreements which encourage foreign sellers to organize in order to restrain their American sales foster those cartels and exporters’ organizations which we have for many years sought to eliminate. Clearly voluntary agreements need to be used with circumspection.

The need to protect U.S. industries from market disruptions in the near future will be reduced significantly by the recent realignment of currencies. Products imported from Japan and many Western European countries will be higher priced in U.S. markets as a result of the revaluations of these currencies. At the same time, the impetus to U.S. export industries from the currency realignments, together with the general thrust of economic expansion, will provide more varied and more productive alternative uses for resources now employed in the industries most vulnerable to imports.

AGRICULTURAL TRADE

International trade in agricultural commodities continues to be impeded by a variety of import restrictions. The economic and social conditions in nearly every major industrialized country present serious problems of adjustment for resources employed in agriculture, quite apart from international trade considerations. Most governments have responded to this problem by adopting domestic price-support measures that are supplemented by restric-
tive trade policies. Tensions over these policies have been growing and surfaced prominently in 1971.

Unlike trade in manufactured products, agricultural trade received little substantive attention in the successive rounds of negotiations which reduced international tariff barriers in the postwar years. Indeed, many developed countries, including the United States, pursued domestic agricultural policies that resulted in an increased level of protection against agricultural imports. This was particularly true in the European Community, where internal prices have been pegged substantially above import prices through a complex system of import levies and export subsidies.

During 1971 the United Kingdom, partly in preparation for EC membership, moved from a consumer-oriented, relatively liberal, import policy toward the EC system by raising minimum import prices on grains and other commodities. The support price to Japanese rice producers was nearly doubled during the 1960's and is one reason why Japan is no longer a significant importer but instead faces burdensome rice surpluses.

The United States has a significant comparative advantage in many agricultural products and therefore has a clear interest in reducing existing impediments to trade in these products. It is also clear that price-support techniques now used in most industrial countries, including the United States, are major impediments to the development of freer trade in agriculture.

Agricultural support policies in the United States have been substantially modified in recent years. Direct payments have been substituted for high price supports for major grains and cotton, commodities that are traditionally exported. This change has permitted market forces to have more influence over actual prices and has reduced the necessity for large export subsidies and import restrictions. The Agricultural Act of 1970 extends these reforms and improves upon them by giving farmers greater freedom in their planning decisions.

Despite these reforms a number of commodities continue to receive support through the price mechanism, and pose problems for a liberal trade policy. Price supports for milk, for example, have been increased over 50 percent in the past 6 years. Partly for this reason and partly because of distortions in world markets caused by similar programs abroad, most dairy imports are now subject to quotas. Four additional dairy products were brought under quotas beginning in 1971. Also, like most developed countries, the United States maintains a sugar program that encourages domestic production through high internal prices. Quotas limit imports and thereby support internal prices. The U.S. sugar program was extended for 3 years in 1971. Several traditional export commodities are supported by limitations on production and substantial export subsidies. About 60 percent of our rice production, for instance, is exported with the aid of export subsidies and concessional sales to developing countries.
There is now realization that agricultural trade is an important item on
the negotiating agenda. There is also agreement that freer trade in agricul-
tural products can occur only if the basic problem of agricultural adjustment
and the techniques for providing assistance to farmers are dealt with in an
international context. As the President's Commission on International Trade
and Investment Policy stated, "the time is ripe for a concerted international
effort to deal with all aspects of the problem including, in particular, the
levels and techniques of agricultural support."

The Commission's analysis, and work done elsewhere, suggest the follow-
ing important guidelines for future negotiations on agricultural trade:

—Discussions over agricultural trade policies will be unproductive
until domestic techniques of support are modified.
—New policies will be needed to aid the adjustment of some resources,
particularly low-income workers, to more productive and higher in-
come pursuits.
—Importing countries must participate with exporting countries in fa-
cilitating adjustment if an improvement in the international use of
resources is to be obtained.
—While each country must be free to provide income assistance to those
employed in agriculture, the mechanisms for this assistance should
minimize interference with production, consumption, and trade.

EAST-WEST TRADE

The widening of the political dialogue between the United States and
Communist nations in 1971 was accompanied by trade expansion measures.

Commercial relations between state-controlled and free-enterprise econ-
omies present problems unlike those which are experienced in trade between
predominantly market-oriented economies. Private firms, for example, can
be at a disadvantage in dealing with large state-trading agencies, and legal
recourse by individual firms against foreign states may be difficult. It is
awkward to apply commercial policy codes that have been negotiated among
governments of market-oriented countries—such as those embodied in the
General Agreement on Tariffs and Trade—to rigorously socialized states.
And the Communist countries can more readily employ economic relation-
ships for political ends than is possible for the free-enterprise states. Further-
more, legislation in the United States and elsewhere places restrictions on
private and public trade and credit in connection with Communist coun-
tries. And regulations in both the Communist countries and the West restrict
the movement of trade representatives. Finally, the Communist states are
not party to a number of important international economic organizations and
conventions.

Several significant changes occurred in U.S. trading relationships with
the Communist countries in 1971. The President's announcements that he
would visit Peking and Moscow in 1972 were preceded by a proclamation
in June lifting the embargo on imports from the People's Republic of China
and freeing a long list of U.S. goods for export to that area. A require-
ment that 50 percent of U.S. exports of wheat, flour, and other grains to
Eastern Europe and the Soviet Union be carried in U.S. vessels was also
lifted. The termination of this requirement facilitated the sale in November
of over $125 million in U.S. feed grains to the Soviet Union—the first such
grain sales since 1964. An amendment to the Export-Import Bank Act in
August authorized the President to extend Export-Import Bank credits to
further exports to Communist countries when he finds this to be in the
national interest. In his first use of this authority, the President directed the
Bank to participate in financing exports to Rumania.

Two Soviet Deputy Ministers of Foreign Trade visited the United States
in 1971, and at the end of the year the U.S. Secretary of Commerce led
a trade delegation from this country to Moscow and Warsaw. U.S.-Soviet
talks on trade and shipping are to be continued in 1972.

GENERALIZED PREFERENCES FOR EXPORTS OF DEVELOPING
COUNTRIES

In October 1969 the President voiced his support for the adoption by all
developed countries of a liberal system of generalized tariff preferences for
the exports of lower-income countries. The step is seen as a means of facilitat-
ing the economic growth of less developed areas by encouraging their inte-
gration into an interdependent world economy. It is also a means of reversing
the trend toward specialized preferences whereby a limited number of devel-
op ing countries have secured access to the markets of particular developed
countries, especially those in the European Community. All too often this
has occurred in conjunction with “reverse preferences” which open the
developing countries’ markets in a discriminatory way. Proposals made by
the members of the OECD were accepted in 1970 by the United Nations
General Assembly as a “mutually acceptable” basis for the establishment of
a generalized preference system. The European Community and Japan have
initiated systems based on their proposals.

Action on Generalized Preferences by the United States was delayed in
1971 by the unsatisfactory state of the balance of payments. The agreement
of December 18 on exchange-rate realignment, in moderating the potential
balance-of-payments problem for the near future, enabled the President on
December 21 to announce his intention to submit Generalized Preference
legislation to Congress in 1972.

A POSITIVE PROGRAM FOR FREER TRADE

In international trade, as in domestic trade, increased specialization and
exchange offer prospects for large gains in productivity. Imports enrich both
consumption and investment by increasing the variety of products available
to users and by lowering their costs. At the same time imports into a country
provide the funds with which other countries can purchase its exports. Re-
ductions in impediments to freer flows of trade, therefore, lead to higher standards of living which are widely shared.

To prevent the changes in patterns of production and consumption which accompany a growing interchange of goods and services from being disruptive, it is important that market adjustments of two kinds take place efficiently:

1. When imbalances develop between the growth of exports and imports, and if these lead to an overall payments imbalance, a mechanism is necessary to bring about corrections. Variations of international exchange rates, by realigning costs and prices among countries, constitute one very efficient process.

2. When changes in demand patterns call for changes in the patterns of production and employment, a mechanism of internal adjustment is needed to make sure that capital and labor in industries which lose market position can shift readily to growing opportunities in other fields.

In 1971 the United States initiated major steps to improve both of these forms of adjustment. Important measures were taken in the international monetary field, notably a significant realignment of exchange rates and a broadening of the band within which exchange rates can move freely. In the domestic economy, general policies were adopted to curb inflation and to expand economic activity and employment opportunities, and work was begun to develop broader arrangements for assisting adjustment by firms and workers affected by the liberalization of trade.

Measures were also taken which can enhance the contribution which two major sectors of the economy make to exports.

One of these sectors is high-technology industry. Such industries require large investments in research and development. This Nation's comparative advantage in the sector depends on its continued technological leadership. To maintain this leadership the Administration has developed proposals to stimulate research and development investment.

The other sector is agriculture. The potential for U.S. agricultural exports is not now realized because serious impediments bar the way to increased trade in agricultural products, mainly in the form of high price supports in important markets abroad. While U.S. agricultural policy has been substantially revised in recent years, away from high price support programs, corresponding action has not been taken in other countries. Negotiations are in progress which have as their goal the reduction of impediments to agricultural trade.

Most of the postwar growth in international trade has come from increased exchange of manufactured products, and it has taken place among the developed nations of the world. As less developed countries move away from heavy reliance on primary production into manufacturing activities, they too will need to participate more actively in the interchange of manufactures. Agreement has been reached among the developed countries of
the world, and between them and less developed countries, on a program through which exports from less developed countries will be given preferential treatment in developed country markets. In the implementation of this program the United States is seeking to minimize the discrimination which developed countries apply to such imports by source and to eliminate the practice by which “reverse preferences” have been granted by some of the developing countries to some developed ones. Legislation to implement a U.S. program in this area is in preparation.

Over the past 20 years the major economies of the world, including the United States, have enjoyed very high rates of growth in output and income. These rates have been higher than anyone predicted at the end of World War II and clearly higher than could have been predicted on the basis of experience prior to that time. One reason that these gains have been possible has been the rapid expansion in the interchange of goods and services that has been brought about by a steady dismantling of impediments to international trade.

Continued progress toward further reductions in existing barriers will require positive policies by both the United States and its trading partners. The international monetary arrangements will have to be made more flexible to accommodate unpredictable changes in world production and consumption patterns. At the same time domestic and international policies will have to provide a milieu of expanding employment opportunities in order to facilitate the reabsorption of resources displaced by change.

If both sets of policies are successful, the shifts which result from change will cease to be feared as harmful dislocations and will be recognized as part of a desirable movement toward higher economic benefits in which most people share.