THE ANNUAL REPORT
OF THE
COUNCIL OF ECONOMIC ADVISERS

LETTER OF TRANSMITTAL

COUNCIL OF ECONOMIC ADVISERS,
Washington, D.C., January 25, 1973.

THE PRESIDENT:

SIR: The Council of Economic Advisers herewith submits its Annual Report, January 1973, in accordance with Section 4(c)(2) of the Employment Act of 1946.

Respectfully,

HERBERT STEIN,
Chairman.

EZRA SOLOMON.

MARINA v.N. WHITMAN.

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CHAPTER 1

The 1972 Record

1972 WITNESSED the first full-year results of the innovative set of economic programs initiated in August 1971 to speed the recovery of the economy, to reduce the rate of inflation, and to reverse the deteriorating trend in the Nation's external position. There was a rapid acceleration in the rate of growth in real output and a slowdown in the rate of inflation (Chart 1). Civilian employment rose sharply and the number of persons unemployed declined. Both real wages and corporate profits increased. Some progress was made on the international front, but it was greatly overshadowed by developments in the domestic economy.

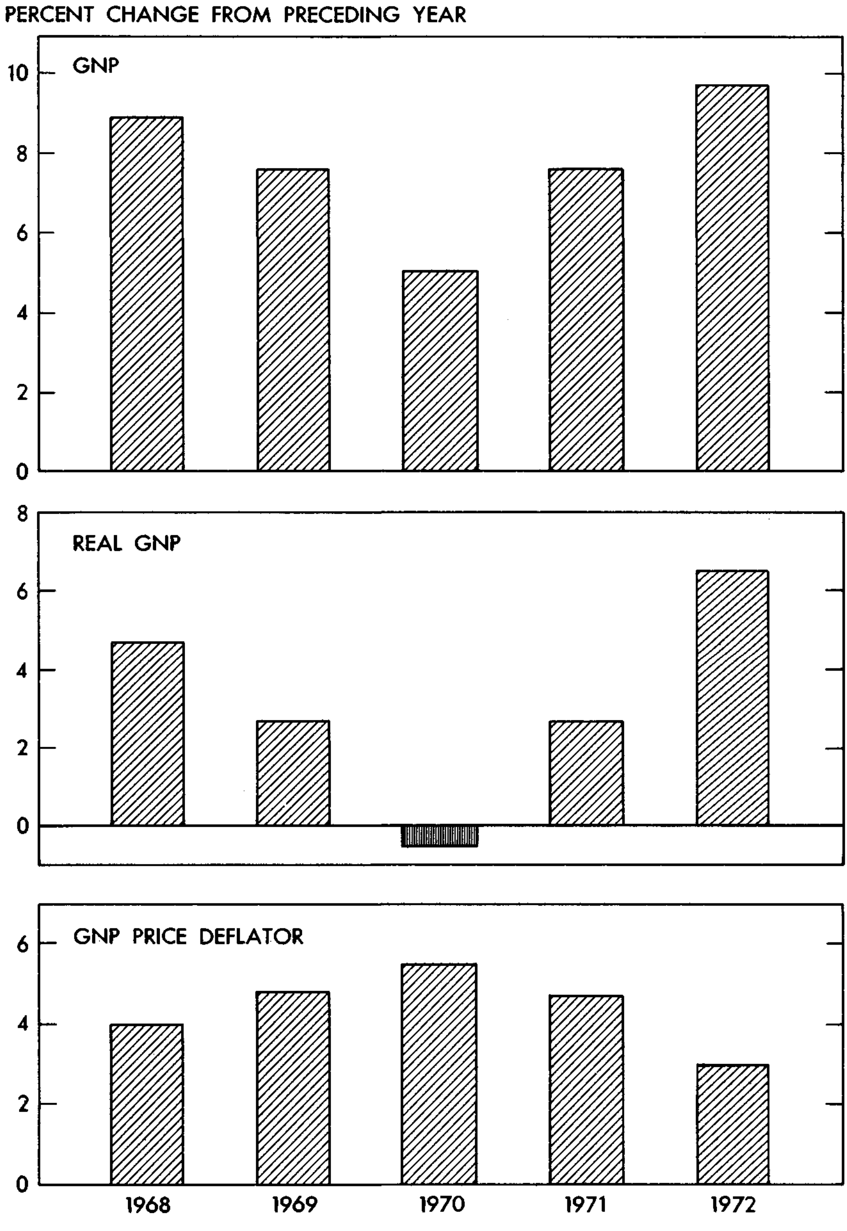
Last year's economic performance brought with it significant changes in public attitudes about inflation and in expectations about the course of the economy. Although hopes were high in early 1972 that the shift in policy would bring favorable results, uncertainties persisted regarding both the strength of the economic expansion and the effectiveness of price and wage controls. These doubts began to abate gradually as evidence grew that rates of wage and price inflation were indeed declining compared to the period prior to August 1971. Workers' cooperation in the wage control system was fostered by the realization that real wages were increasing. Strike activity fell and relative to total time worked was at its lowest point in almost 10 years. Although increases in food prices were troublesome during most of 1972, consumers could see a slower rise in the overall cost of living. Finally, although selling prices were constrained, so were costs, and business was able to enjoy some rise in profit margins in a setting of rapidly rising volume. These developments were all parts of a process that was one of the major objectives of the price-wage control system—the unwinding of inflationary expectations.

Nor was the change in attitudes confined to inflation alone. The rise in production and employment that became particularly evident by midyear created a growing mood of confidence among businessmen and consumers, and this in turn helped to bolster private investment and personal consumption expenditures.

The fact that considerable progress was made during 1972 did not mean that final goals had been reached. The unemployment rate in December 1972, although down by nearly 1 percentage point from a year earlier, was still higher than desirable. At the same time, the rate of inflation at the end

Chart 1

Changes in GNP, Real GNP, and Price Deflator



SOURCE: DEPARTMENT OF COMMERCE.

of 1972, although lower than it had been before the controls, was still higher than the ambitious target set by the Administration. The balance of payments still showed a considerable deficit, and although work on international monetary reform was underway it had only begun. Nonetheless by the end of 1972 there was a strong sense of optimism about the progress that had been achieved and the ability to find answers to some of the problems that remained.

DEMAND AND OUTPUT

Last year's expansion in demand and its division between real output and prices exceeded most expectations held at the start of 1972. The $102 billion increase in gross national product (GNP) from 1971 to 1972 was close to the figure projected by the Council, but the 6.5-percent rise in real GNP was higher than projected, while the 3.0-percent rise in prices was a little lower. Real growth was the largest and the price rise as measured by the GNP deflator the smallest since 1966.

All major sectors of demand, except for net exports, contributed to the rise in overall GNP (Table 1). The very large increase in gross private domestic investment, the step-up in Federal purchases in the first half of the year, and the large increase in consumer spending were the principal stimulating forces in the economy. The continued buoyancy of housing demand and the strength of consumption in the face of overwithholding of personal income taxes were noteworthy developments in 1972.

The policy measures initiated in August 1971 changed both the character and the pace of the recovery that began at the end of 1970. In its first full year it was weaker than in comparable periods of past cyclical upswings. Indeed, that was one of the main reasons for the shift in policy. After the pronounced acceleration that occurred during 1972 the current expansion compares very favorably with previous upswings, when changes are taken from the preceding peak to the eighth quarter after the trough (Chart 2).

BUSINESS FIXED INVESTMENT

Business fixed investment showed considerable strength in 1972—much more than the Council of Economic Advisers and most forecasters had anticipated at the start of the year. The comprehensive measure included in the national income accounts (NIA)—nonresidential fixed investment—rose 14 percent. The real increase of 10 percent was confined to equipment, since on this basis nonresidential construction was unchanged. Investment was bolstered by the general incentives provided by the liberalized depreciation regulations, the job development credit, and the excise tax cuts on motor vehicles. The strong upsurge in the economy in 1972, the rise in profits and cash flow, and the ready availability of funds at lower interest rates than in 1971 also benefited investment. However, last year's buoyant economy and favorable financial setting had their main impact on decisions and

TABLE 1.—*Changes in gross national product in current and constant dollars, 1968 to 1972*

Component	1968 to 1969	1969 to 1970	1970 to 1971	1971 to 1972 [1]
CURRENT DOLLARS				
Percent change:				
Total GNP	7.6	5.0	7.6	9.7
Personal consumption expenditures	8.1	6.4	7.8	8.5
Durable goods	8.0	−.3	14.4	12.4
Gross private domestic investment	10.3	−1.3	10.9	18.6
Fixed investment	10.3	.8	12.2	17.5
Business fixed investment	10.9	2.5	4.8	13.8
Residential structures	8.5	−4.3	36.4	26.5
Government purchases	5.2	4.3	6.3	9.5
Federal purchases	.0	−2.3	1.3	8.3
State and local purchases	10.3	10.2	10.2	10.3
Change in billions of dollars:				
Inventory accumulation	.7	−2.9	−1.3	2.2
Net exports of goods and services	−.6	1.7	−2.9	−4.8
CONSTANT (1958) DOLLARS				
Percent change:				
Total GNP	2.7	−.5	2.7	6.5
Personal consumption expenditures	3.6	1.7	3.9	5.9
Durable goods	5.3	−2.9	10.8	11.9
Gross private domestic investment	5.0	−5.9	4.4	14.0
Fixed investment	5.1	−3.8	6.0	12.7
Business fixed investment	6.0	−3.1	−1.0	9.8
Residential structures	2.2	−5.9	30.5	20.3
Government purchases	−1.2	−4.7	−1.0	3.9
Federal purchases	−5.9	−12.0	−6.0	1.3
State and local purchases	4.0	2.6	3.4	5.9
Change in billions of dollars:				
Inventory accumulation	.3	−2.6	−1.5	1.9
Net exports of goods and services	−.8	2.0	−2.1	−1.9

[1] Preliminary.

Source: Department of Commerce, Bureau of Economic Analysis.

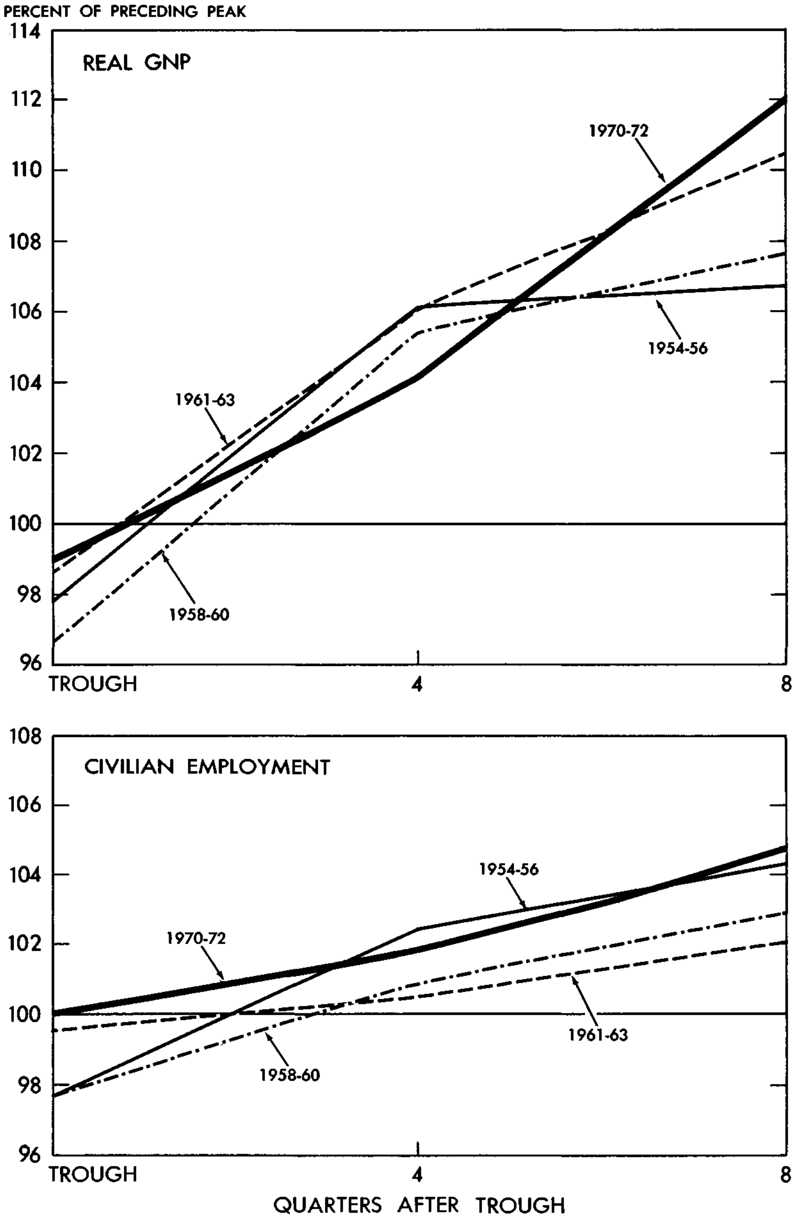
commitments to invest. Because of the lag between the investment decision and actual investment, a large portion of this impact will manifest itself in rising outlays in 1973.

At the start of the year the main reason for expecting that the rise in investment in 1972 would be moderate was the relatively low rate of capacity utilization, especially in manufacturing. In this sector, investment did not increase very much. After a 6-percent drop in the preceding year, dollar outlays were up only 4 percent in 1972, or about as much as the rise in capital goods prices. The recent behavior of manufacturing investment has been more or less typical of past business cycles. In the early 1960's, for example, manufacturing investment did not strengthen to any significant degree until 1964, the third year of the recovery.

Most of the increase in investment outlays in 1972 was concentrated in the nonmanufacturing sector, where increases by electric and gas utilities, communications firms, and the airlines were especially large. In many of the nonmanufacturing industries investment tends to be rather independent

Chart 2

Recovery Comparisons of Real GNP and Civilian Employment



NOTE: PEAK AND TROUGH QUARTERS, AS DESIGNATED BY THE NATIONAL BUREAU OF ECONOMIC RESEARCH, ARE: PEAKS, 1948 IV, 1953 II, 1957 III, 1960 II, AND 1969 IV; TROUGHS, 1949 IV, 1954 III, 1958 II, 1961 I, AND 1970 IV.

SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR (EXCEPT AS NOTED).

of the short-run cyclical behavior of the economy. Also, investment by farmers was up very sharply as a result of rising farm income, and business purchases of items affected by the excise tax cut—such as trucks—rose substantially.

Investment plans and forward commitments were much stronger than actual investment spending during 1972. This showed up in many ways. In November, new orders received by producers of capital goods were 23 percent above the year-earlier figure, and construction contracts for commercial and industrial buildings were up by 20 percent. In manufacturing, the 19-percent rise in new appropriations for future spending and the 23-percent rise in the total value of new investment projects started in the first 3 quarters of 1972 were far greater than the small increase in actual outlays from 1971 to 1972.

HOUSING

Almost 2.4 million private housing units were started last year, a rise of approximately one-sixth over the 1971 total. Shipments of mobile homes also rose considerably. The 1972 housing performance exceeded the Council's projection of 2.2 million units, which itself was at the high end of the range of housing forecasts for 1972. Total outlays for residential construction rose by more than one-fourth to nearly $54 billion.

The rise in starts reflected exceptionally strong demand for housing and favorable conditions for an increase in mortgage credit. In the single-family housing market, sales were at a peak, vacancy rates were low, and pressures on home prices were strong. The demand for apartment units was also high, although vacancy rates in rental units edged up for the second year in a row.

Last year's rise in housing starts occurred in spite of a decrease in starts under federally assisted home programs. Some 318,000 private housing units were started in 1972 under federally subsidized programs, or 13½ percent of the total. This compares with 408,000 units, or 20 percent, of total starts in 1971 and 400,000 units, or 28 percent, of total starts in 1970.

Conditions in mortgage markets were extremely favorable for home construction and purchasing in 1972, but the primary driving force was a strong underlying demand for shelter. Part of this strength was a legacy of earlier years. The level of new housing construction was relatively low in the 1960's, particularly in the second half of the decade, when credit conditions were generally unfavorable for housing. Once credit conditions began to improve, as they did in 1970, much of the unsatisfied backlog of demand reasserted itself. At the same time the pace of new household formation has been rising rapidly. New household formation totaled about 1.9 million in 1971 and 1.5 million in 1970 as compared to an average of 1.1 million in the preceding 5 years. Despite the fact that starts rose to new records in the last 2 years, housing vacancies are still low in relation to those of the past 15 years (Table 2).

TABLE 2.—*Annual vacancy rates for rental and homeowner housing, 1956–72*

Year	Vacancy rate (percent)[1]		
	Total	Rental	Homeowner
1956	2.7	5.5	0.9
1957	2.4	5.1	.9
1958	2.9	5.9	1.1
1959	3.0	6.4	1.1
1960	3.4	7.4	1.2
1961	3.6	7.9	1.3
1962	3.5	7.4	1.3
1963	3.5	7.5	1.4
1964	3.5	7.5	1.4
1965	3.5	7.5	1.4
1966	3.3	7.0	1.3
1967	2.9	6.2	1.2
1968	2.5	5.4	1.0
1969	2.3	5.0	.9
1970	2.3	4.9	1.0
1971	2.4	5.1	.9
1972 [2]	2.4	5.2	.9

[1] Excludes dilapidated units.
[2] Estimates by Council of Economic Advisers.

Source: Department of Commerce, Bureau of the Census (except as noted).

CONSUMER SPENDING

Consumer spending increased by over $56 billion in 1972. The nominal increase of 8½ percent and the real increase of 6 percent were among the largest recorded in the past 20 years. The general improvement in the economy, rising employment and income, and the slowdown in both inflation and inflationary expectations all affected the consumer's ability and willingness to spend. Consumers made extensive use of credit to finance their purchases, particularly of durable goods.

The boom in residential housing brought with it the largest gains in spending on furniture and appliances since 1964. The lower level of automobile prices in 1972, as a result of the 1971 excise tax cut, was partly responsible for dealers' sales of 10.9 million new cars. Almost all of the 7-percent rise over 1971 was accounted for by domestic-type cars.

Underlying last year's buoyant consumer demand was a rise in personal income of 8.6 percent, well above average for the preceding decade. In 1970 and 1971, when the economy was sluggish, rising transfer payments accounted for a significant share of the income increase. In contrast, most of the 1972 rise in income reflected larger earned income. But the outstanding feature of consumer behavior in 1972 was the strength in consumer spending, despite the overwithholding of personal income taxes that began at the start of the year. Because of overwithholding, the 6.8 percent rise in disposable (after-tax) income was roughly 1 percentage point less than the rise otherwise associated with an 8½-percent rise in personal incomes. Apparently in 1972 consumers largely ignored the temporary effects of overwithholding. In any case, most of the rise in the proportion of personal income going to higher taxes was compensated for by a reduction in the proportion of income devoted to saving. As Table 3 shows, the ratio of personal outlays to income was little changed from 1971. The table also shows that the share of income devoted to personal outlays last year continued relatively low compared to the 1960's.

TABLE 3.—*Personal outlays, taxes, and saving as percent of personal income, 1960–72*

[Percent]

Year	Personal income	Personal outlays	Personal taxes	Personal saving
1960–72 average	100.0	80.7	13.6	5.7
1960	100.0	83.1	12.7	4.2
1961	100.0	82.4	12.6	5.1
1962	100.0	82.2	13.0	4.9
1963	100.0	82.6	13.1	4.3
1964	100.0	82.8	11.9	5.3
1965	100.0	82.5	12.2	5.3
1966	100.0	81.6	12.8	5.5
1967	100.0	80.4	13.2	6.4
1968	100.0	80.0	14.2	5.8
1969	100.0	79.4	15.5	5.1
1970	100.0	78.7	14.5	6.8
1971	100.0	79.3	13.6	7.1
1972[1]	100.0	79.1	15.0	5.9

[1] Preliminary.

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce, Bureau of Economic Analysis.

THE LABOR MARKET

Two forces dominated the labor market in 1972. First, there was a large expansion in opportunities for civilian employment. According to the household survey, civilian employment increased by more than half a million jobs in each quarter of the year, and for 1972 as a whole there were 2.3 million more people at work than in 1971. This was the largest year-to-year percentage change since 1955. At the same time, the civilian labor force expanded sharply, and not until the middle of the year were the large employment gains accompanied by noticeable reductions in unemployment.

THE LABOR FORCE

The year 1972 witnessed a large influx into the civilian labor force, which expanded by 2.1 million relative to 1971 (Table 4). One factor contributing to this increase was a reduction in the size of the Armed Forces, which fell by about 400,000 and enlarged the pool of persons available for civilian work. Returning veterans have a very high propensity to join the civilian labor force—participation rates for recent veterans averaged more than 90 percent over the past few years—so that a shift in the size of the Armed Forces by itself will change the overall civilian participation rate. However, in 1971, when the size of the Armed Forces also fell by 400,000, the civilian participation rate dipped. The difference between the 2 years lies in the increased labor force participation of other groups, notably women and teenagers.

TABLE 4.—*Changes in the working-age population, Armed Forces, and labor force, 1962 to 1972*

Group	Change (millions of persons, 16 years and over)				
	1962 to 1965 average	1965 to 1968 average	1968 to 1970 average	1970 to 1971	1971 to 1972 [1]
Noninstitutional population	2.1	2.1	2.3	2.4	2.4
Total labor force	1.2	1.7	1.8	1.0	1.7
Armed Forces	([2])	.3	−.2	−.4	−.4
Civilian labor force	1.3	1.4	2.0	1.4	2.1
Both sexes 16–19 years	.3	.2	.3	.2	.5
Men 20–24 years	.2	.1	.3	.5	.4
Men 25–54 years	.1	.2	.3	.2	.6
Men 55 years and over	([3])	.1	.1	−.1	−.1
Women 20–24 years	.2	.3	.3	.2	.2
Women 25–54 years	.3	.4	.6	.3	.6
Women 55 years and over	.2	.1	.1	.1	([3])

[1] Data for 1972 have been adjusted for comparability with data for 1971.
[2] Decrease of less than 50,000.
[3] Increase of less than 50,000.

Note.—Detail may not add to totals because of rounding.

Source: Department of Labor, Bureau of Labor Statistics.

Chart 3 shows trends in the participation rates of the major age and sex groups in the civilian labor force. For a number of groups, participation rates, which had leveled off or declined in 1971, rose in 1972 as the recovery strengthened. The tendency for women in the 20–24-year age bracket to enter the labor force had grown steadily throughout the 1960's and into 1970 as more young wives chose either to delay the start of a family in favor of working or to continue working even after starting a family; the participation rate for this group leveled off in 1971 but resumed its longer-run growth in 1972. A similar pattern was evident for women in the 25–54-year age bracket. Participation rates of teenagers, which had risen sharply in the last half of the 1960's and 1970, dipped in 1971 but rose again in 1972.

The participation rates for young men in the 20–24-year age group have been particularly affected by changes in the size of the Armed Forces. Civilian labor force participation for this group had been declining since the mid-1960's as more and more young men were absorbed into the Armed Forces and others continued their schooling through the college level. The participation rates declined through 1968 and, after remaining about level through 1971, rose in 1972.

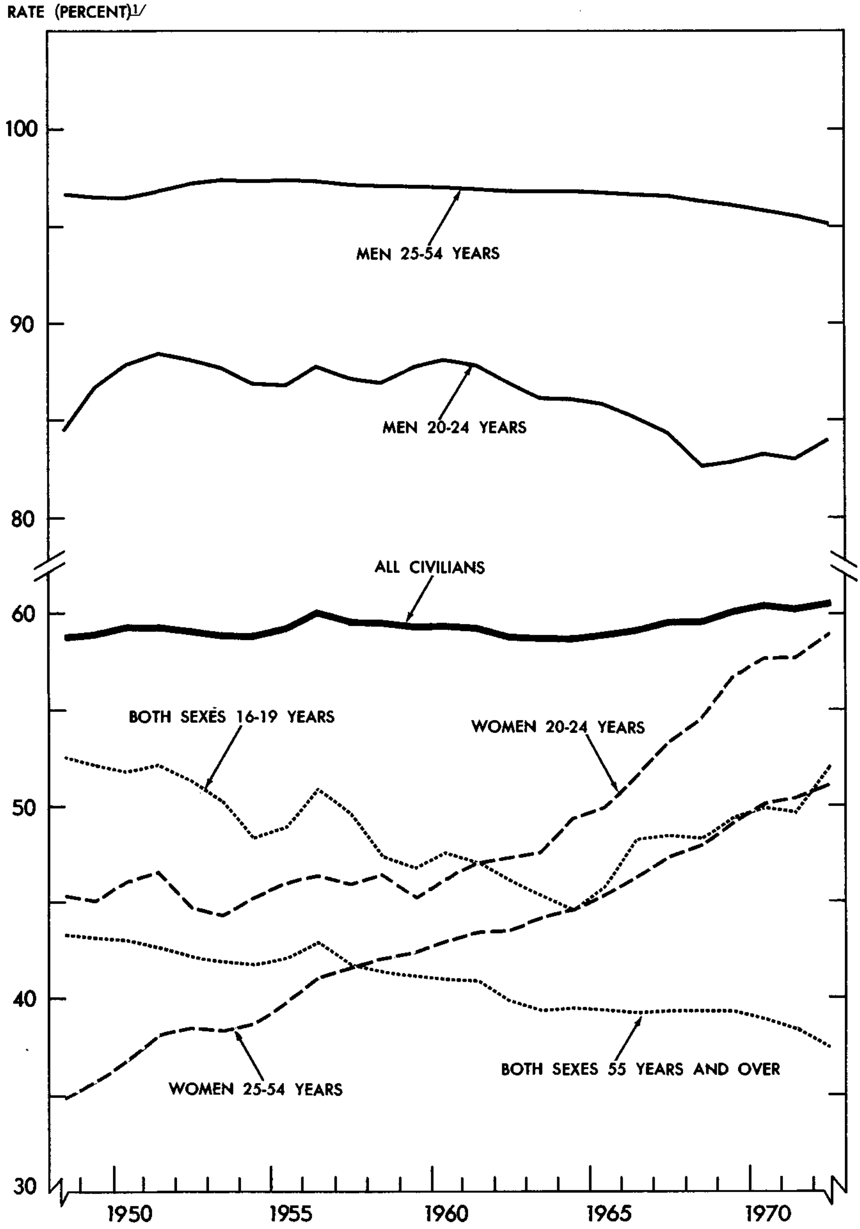
Finally, participation rates of men in the prime working-age group (25–54) and of all persons 55 or older fell again in 1972. The spread of private pension plans, the liberalization of both private and public pension plans, and the improvement in disability benefits are important reasons for the decreasing trend in participation rates of these groups.

EMPLOYMENT GAINS IN 1972

From the fourth quarter of 1971 to the fourth quarter of 1972, real output rose 7.7 percent, creating exceptionally strong demands for labor.

Chart 3

Civilian Labor Force Participation Rates



1/ CIVILIAN LABOR FORCE AS PERCENT OF CIVILIAN NONINSTITUTIONAL POPULATION IN GROUP SPECIFIED.

SOURCE: DEPARTMENT OF LABOR.

Employment expanded sharply according to both of the major employment measures, the household survey and the payroll survey. According to the latter survey, 2.7 million more persons were at work in nonagricultural establishments in the fourth quarter of 1972 than in the corresponding quarter a year earlier (Table 5).

The goods-producing sector, whose employment declined in the first year of the recovery, made a strong advance in 1972. The sharpest turnaround was in durable goods manufacturing, where employment expanded in each of the past 5 quarters, following 2 years of contraction. These strong gains notwithstanding, manufacturing employment in the fourth quarter of 1972 was still 4 percent below its level at the business cycle peak in the fourth quarter of 1969, largely because of the reduced level of defense-related manufacturing. In the private sector, manufacturing and mining were the only industry divisions for which employment was below levels prevailing in the fourth quarter of 1969.

Employment in the service-producing industries, which had continued to rise during the recession and in 1971 but at less than the trend rate of increase, moved up strongly in 1972. State and local governments added almost 500,000 employees to their payrolls. Although the major part of this gain is attributable to the increased demand for local government services, the 1972 rise was augmented by employment financed by the Federal Public Employment Program. The only service category for which employment fell over the 4-quarter period was the Federal Government; here, the decline that began in 1969 continued.

TABLE 5.—*Change in the number of employees on nonfarm payrolls, 1969 IV to 1972 IV*

[Seasonally adjusted]

Industry group	Change (thousands of persons)						
	1969 IV to 1970 IV	1970 IV to 1971 IV	1971 IV to 1972 IV	1971 IV to 1972 I	1972 I to 1972 II	1972 II to 1972 III	1972 III to 1972 IV [1]
Total	−771	983	2,698	684	743	428	843
Goods producing industries	−1,612	−53	865	185	260	70	350
Mining	0	−73	55	62	−11	−1	5
Construction	−98	123	27	23	16	2	−14
Manufacturing	−1,514	−103	783	100	255	69	359
Durable goods	−1,258	−37	633	70	193	87	283
Nondurable goods	−256	−66	150	30	62	−18	76
Service producing industries	841	1,036	1,833	499	483	358	493
Transportation and public utilities	−4	−54	133	46	27	−4	64
Wholesale and retail trade	103	362	601	154	177	123	147
Finance, insurance, and real estate	94	129	131	29	37	27	38
Services	297	280	502	110	142	131	119
Federal Government	−69	5	−28	5	−12	−37	16
State and local government	419	316	493	155	110	119	109

[1] Preliminary.

Note.—Changes are based on quarterly averages.
Detail may not add to totals because of rounding.

Source: Department of Labor, Bureau of Labor Statistics.

The underlying strength in the labor market is confirmed by recent trends in the labor turnover data. In manufacturing, the rate of new hires (the number of new workers hired per 100 employees) had drifted down from 3.8 in the first quarter of 1969 to 2.4 in the first quarter of 1971. Since that low point the pace of new hires has increased steadily, reaching an average of 3.7 in October and November of 1972. The quit rate in manufacturing has also increased recently, indicating that many workers are finding better job prospects. Correspondingly, layoffs have decreased sharply—from an average of 1.8 per 100 workers in 1970 to half that rate in October and November, the lowest rates since the Korean war. A further indication of the expansion of employment opportunities is the recent upturn in job vacancies in manufacturing. The number of unfilled jobs in manufacturing, while still low in relation to 1969, has increased by nearly 70 percent since the end of 1971.

The increases in payroll employment were accompanied by gains in hours worked. Average weekly hours of production workers in manufacturing rose from 40.1 in the fourth quarter of 1971 to 40.9 in the fourth quarter of 1972, the highest level since late 1968. For the entire nonfarm sector, where the average workweek has followed a pronounced downward long-term trend, average weekly hours lengthened slightly in 1972.

UNEMPLOYMENT

Although unemployment responded relatively slowly to the large output and employment gains of 1972, there were unmistakable signs of progress. In the fourth quarter, the number of unemployed adjusted for seasonality averaged 4.6 million persons, down from the 5.0-million average of 1971 and the first half of 1972. The overall unemployment rate, which had hovered around 6 percent throughout 1971, began moving down in 1972 and by December had reached 5.1 percent.

Partly because of the upsurge in durable goods output, the improvement in the unemployment picture over the past 4 quarters was more marked for adult males than for adult females (Table 6). The unemployment rate for married men fell to 2.6 percent in the fourth quarter and to 2.4 percent by December. Although the latter was above the very low rates of the late 1960's, it was less than in any other period since early 1957. The unemployment rate for household heads also declined in 1972, but not so markedly as the rate for married men. Unemployment among teenagers reached an all-time high in the first quarter of 1972 but has since receded somewhat.

The unemployment rate for nonwhite workers declined over 1972, but not so rapidly as did the rate for whites. However, the changes in the overall rates by race obscure widely divergent changes in unemployment for the different age and sex groups. There were sizable employment gains for nonwhite adult males, whose unemployment rate declined from 7.9 percent in the fourth quarter of 1971 to 6.1 percent a year later. This decline was much larger, both absolutely and relatively, than the decrease from 3.9 percent to 3.3 percent experienced by white adult males. The widening in the gap between white and nonwhite unemployment rates on an overall basis was apparently attributable to differences in the behavior of unemployment among teenagers.

TABLE 6.—*Selected unemployment rates, 1970 IV–1972 IV*

[Percent; seasonally adjusted [1]]

Selected groups of workers	1970 IV	1971 IV	1972			
			I	II	III	IV
All workers [2]	5.8	5.9	5.8	5.7	5.6	5.3
Sex and age:						
Both sexes 16–19 years [2]	17.2	17.0	17.8	15.8	16.1	15.6
Men 20 years and over [2]	4.2	4.4	4.1	4.1	3.9	3.6
20–24 years	10.5	10.3	10.0	9.5	8.9	8.6
25 years and over	3.4	3.5	3.2	3.3	3.0	2.8
Women 20 years and over [2]	5.5	5.7	5.4	5.6	5.5	5.2
20–24 years	8.7	9.4	9.1	9.6	9.7	9.1
25 years and over	4.8	4.9	4.5	4.7	4.6	4.4
Race:						
White	5.4	5.4	5.3	5.3	5.0	4.7
Negro and other races	9.2	10.1	10.6	9.9	9.9	9.8
Occupation:						
White-collar workers	3.4	3.5	3.5	3.4	3.4	3.3
Blue-collar workers	7.5	7.4	7.0	6.6	6.3	5.8
Service workers	6.0	6.4	6.2	6.0	6.7	6.3
Other categories:						
Household heads	3.5	3.6	3.4	3.5	3.3	3.1
Married men	3.2	3.2	2.9	2.9	2.7	2.6
Full-time workers	5.4	5.6	5.4	5.3	5.1	4.8
Part-time workers	8.4	8.4	8.7	8.5	8.5	8.5
State insured workers [3]	4.3	4.2	3.5	3.6	3.5	3.2
Reason for unemployment [4]:						
Lost last job	2.8	2.7	2.5	2.5	2.5	2.2
Left last job	.7	.7	.7	.7	.7	.8
Reentered labor force	1.6	1.7	1.8	1.6	1.7	1.6
Never worked before	.7	.8	.9	.9	.7	.7

[1] Unemployment as percent of civilian labor force in group specified unless otherwise indicated.
[2] Reflects revisions for 1971-72. See Note, Appendix Tebles C-24-26.
[3] Insured unemployment under State programs as percent of average covered employment.
[4] Unemployment as percent of total civilian labor force.

Source: Department of Labor, Bureau of Labor Statistics.

Last year witnessed a decisive improvement in the labor market status of recent veterans. The unemployment rate for Vietnam-era veterans in the 20–29-year-old age group, which had averaged 8.8 percent in 1971, declined to 6.1 percent in the final quarter of the year. Moreover, the unemployment rate decline for veterans was faster than for nonveterans in the 20–29 age group, so that by yearend the veteran unemployment rate was actually below the nonveteran rate, after remaining persistently above it for the past several years. A number of forces explain these developments. They reflect the general improvement in economic conditions as well as specific Government policies directed toward aiding the labor market adjustments of veterans. The stabilization of the size of the Armed Forces during the course of the year also helped, since it reduced the flow of discharged veterans from 100,000 per month at the start of the year to about 50,000 toward yearend. Moreover, the average age of the Vietnam-era veteran has been rising, and there is a strong inverse relationship between age and unemployment for veterans and nonveterans alike.

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There was also considerable improvement in the distribution of unemployment along geographic lines. This is most readily apparent in the Labor Department's monthly classification of the unemployment situation in 150 labor market areas. From the end of 1971 to the end of 1972, the number of areas with "low" unemployment (less than 3.0 percent) almost trebled—from 6 to 17 areas. Areas with "moderate" unemployment (from 3.0 to 5.9 percent) increased from 84 to 88. On the other hand, there was a sharp reduction—from 60 to 45—in the number of areas classified in the "substantial" unemployment categories, i.e., 6.0 percent or more.

PRICES AND COSTS

In the period since the August 1971 policies were instituted there has been a dramatic deceleration in the rate of inflation. This is discussed in detail in Chapter 2; here we focus mainly on price measures applicable to the GNP. For example, the implicit price deflator for GNP, which measures the change in prices of all goods and services included in the gross national product, rose at a rate of 5.2 percent per year in the 3 years ending in the second quarter of 1971, the last full quarter before the policy shift. Over the next 6 quarters, the annual rate of increase was down to 2.7 percent.

The GNP deflator is the only measure of price that is consistent with real GNP; the product of the two equals GNP in current dollars. However, changes in the deflator reflect shifts in the composition of real GNP as well as changes in individual prices. Changes in the composition of GNP in 1972 had a downward effect on the rate of inflation as measured by the general GNP deflator. This compositional effect is eliminated by the Commerce Department through the construction of an index of GNP prices with fixed base period weights—the general type of construction used for the consumer price index (CPI) and wholesale price index (WPI).

On the basis of a GNP price index that uses fixed 1967 weights, the rate of price increase experienced over the past 6 quarters is 3.6 percent rather than 2.7 percent. Even so, this represents a marked improvement relative to the period prior to August 1971 (Table 7). For some analytical purposes it is useful to focus on the private sector, which excludes Government workers and their pay raises. For the private sector of the economy, the fixed-weight deflator shows an inflation rate of just over 3 percent since the second quarter of 1971, as against an average increase of 4.7 percent over the 3 preceding years.

Although the rate of inflation slowed last year in most broad sectors of the economy, farm prices were one important exception. The sharp rise in farm prices had a significant effect on the overall rate of inflation. If attention is confined to private nonfarm business, as shown in the last column of Table 7, the deceleration of the price rise is clearly more pronounced than it is for the GNP deflator as a whole or even the private deflator. In the private nonfarm sector inflation declined from a rate of

4.6 percent in the 1968–71 period to 1.7 percent over the past year and a half.

TABLE 7.—*Changes in gross national product price deflators, 1968 II to 1972 IV*

[Percent change; seasonally adjusted annual rates]

Period	GNP		Private GNP		Private nonfarm business GNP
	Implicit deflator	1967 weights	Implicit deflator	1967 weights	Implicit deflator
1968 II to 1969 II	4.7	4.7	4.4	4.5	4.2
1969 II to 1970 II	5.6	5.8	4.8	5.1	4.9
1970 II to 1971 II	5.2	5.2	4.8	4.7	4.7
1971 II to 1972 IV [1]	2.7	3.6	2.4	3.1	1.7
1971 II to 1971 III	2.9	3.5	2.8	3.5	2.4
1971 III to 1971 IV	1.5	2.5	1.0	1.7	.0
1971 IV to 1972 I	5.1	6.1	4.2	4.5	3.6
1972 I to 1972 II	1.8	3.0	1.7	2.5	1.2
1972 II to 1972 III	2.4	3.1	2.2	2.9	1.2
1972 III to 1972 IV [1]	2.7	3.4	2.7	3.3	2.1

[1] Preliminary.

Source: Department of Commerce, Bureau of Economic Analysis.

COMPENSATION, PRODUCTIVITY, AND COSTS

The slowing of price inflation in the private nonfarm economy reflects a marked deceleration in the rise in unit costs. For labor costs, this was a result of two factors: a slower rise in hourly compensation and an acceleration of the rise in output per man-hour (Chart 4).

Compensation

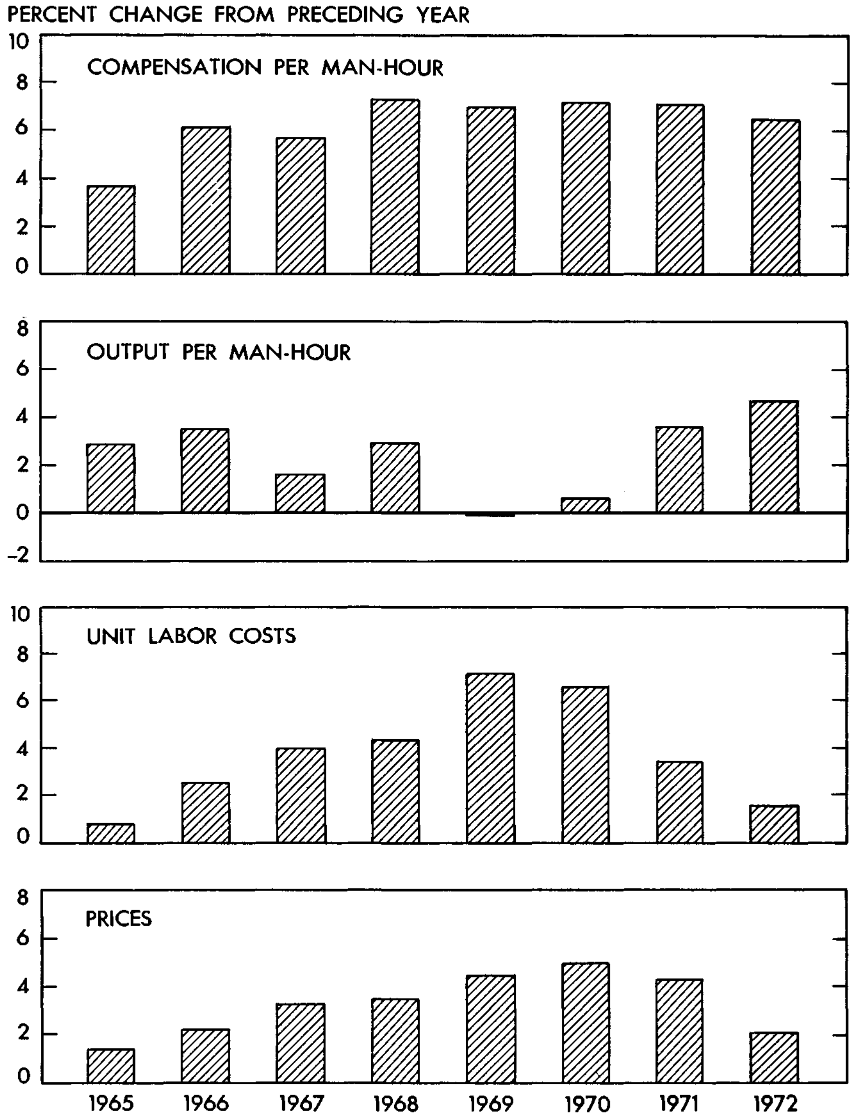
Although fiscal and monetary policies moved the economy away from the conditions of excess demand that persisted into 1969, hourly compensation continued to rise at rates of 7½ percent or more per annum in early 1971 (Table 8). These large increases occurred not only in the face of generally slack labor market conditions, but in spite of two associated factors that tend to reduce the rise in average hourly compensation during such periods. During an economic slowdown, increases in average hourly compensation (which includes premium payments for overtime hours) are normally dampened because the proportion of overtime hours usually falls. A second factor is the changed composition of employment. Some of the relatively highly paid industries, like durable goods manufacturing, are those most affected by an economic slowdown, and this restrains the average increase in hourly compensation for the economy as a whole.

Since the second quarter of 1971, just before the start of the stabilization program, the rise in hourly compensation for all persons in the private nonfarm sector has slowed to an annual rate of about 6 percent. In terms of quarter-to-quarter changes, the 90-day wage-price freeze restrained the increase in the fourth quarter of 1971. The sharp step-up in the first quarter

Chart 4

Changes in Compensation, Productivity, Labor Costs, and Prices

Private Nonfarm Sector



NOTE: DATA RELATE TO ALL PERSONS.
SOURCE: DEPARTMENT OF LABOR.

of 1972, when hourly compensation rose at about a 9-percent rate, reflected the bulge after the end of the freeze and the increase in social security taxes. This was followed by a very small increase of 4.6 percent during the second quarter. The apparent step-up during the final 2 quarters of 1972 may be more a reflection of the timing of wage increases—which has undoubtedly been affected by the controls program—than of an underlying acceleration of wage inflation. Over the last 3 quarters of 1972, hourly compensation rose at an average annual rate of 6 percent, which would seem to be a fair representation of post-bulge experience.

TABLE 8.—*Changes in hourly compensation, private nonfarm sector, 1967–72*

[Seasonally adjusted annual rates]

Period	Percent change from previous quarter	Period	Percent change from previous quarter
1967: I	4.3	1970: I	6.5
II	6.3	II	7.2
III	6.3	III	9.0
IV	5.4	IV	4.6
1968: I	9.9	1971: I	9.1
II	6.2	II	7.5
III	7.4	III	5.2
IV	8.8	IV	4.9
1969: I	5.7	1972: I	9.1
II	6.9	II	4.6
III	6.5	III	6.1
IV	8.8	IV [1]	7.4

[1] Preliminary.

Note.—Data relate to all persons.

Source: Department of Labor, Bureau of Labor Statistics.

Productivity

Changes in productivity (which is usually measured in terms of real output per hour of work) show cyclical movements around an upward trend. Longer-term growth in productivity reflects such basic developments as the rising educational attainment and skill levels of the work force as well as changes in the quantity and quality of the tools, equipment, and organization with which they work. The short-run variability in productivity is highly influenced by changes in the industry mix of output and in production rates. Some of the work force in each unit, such as skilled maintenance personnel, represent relatively fixed overhead inputs, in the sense that they must be kept on even when the level of production declines. Also, if the period of slack production is expected to be brief, employers may refrain from laying off workers. While these adjustments hold down increases in output per man-hour of paid labor during periods of slack, they also help to explain why increased output can be had with a substantially less than proportionate rise in labor inputs during the subsequent recovery phase.

The behavior of productivity during the recovery from the 1970 recession falls neatly into two separate phases, each of which is different from earlier experiences at comparable stages of expansion. The basis for this disparity appears to be related to the different pattern of ouput growth in this expansion as compared to earlier ones.

Reflecting the slow growth in real output, the rise in productivity during the first 3 quarters of 1971 was clearly below the experience in previous recoveries (Table 9). Indeed, the rise was even weaker than the measures in Table 9 show. This is so because productivity in the final quarter of 1970 was depressed by the lengthy strike at General Motors. If, as seems reasonable, a more representative value of output per man-hour during the trough quarter was the average of the final quarter of 1970 and the first quarter of 1971—when there was a very substantial amount of makeup production from the strike—then the growth of productivity over the first 3 quarters of 1971 was closer to 3 percent than to the 4.4 percent shown in the table. The lower figure is about half the average growth rate of productivity in the preceding four recoveries.

With the acceleration in the rise of real output since late 1971, productivity has grown very strongly. Starting in late 1971 and throughout 1972, productivity growth has been much more pronounced than that experienced during corresponding phases of previous recoveries.

Unit Labor Costs

Because compensation per man-hour and output per man-hour during the recent slowdown and current recovery have behaved differently from past cyclical experience, unit labor costs have also traced an unusual pattern of change (Table 9). In past recoveries, labor costs per unit of output began

TABLE 9.—*Changes in unit labor costs, productivity, and compensation per man-hour in recessions and expansions, private nonfarm economy*

[Seasonally adjusted annual rates]

Peak and trough quarters[1]	Peak to trough	Trough to third quarter after trough	Third to eighth quarter after trough
Compensation per man-hour:			
1948 IV, 1949 IV	0.4	8.3	8.6
1953 II, 1954 III	3.3	3.4	5.7
1957 III, 1958 II	3.3	5.1	4.2
1960 II, 1961 I	1.7	5.0	3.7
1969 IV, 1970 IV	6.8	7.2	[2] 6.4
Productivity[3]:			
1948 IV, 1949 IV	3.1	9.2	2.2
1953 II, 1954 III	2.4	5.1	−.6
1957 III, 1958 II	1.7	4.7	1.4
1960 II, 1961 I	.0	7.0	3.4
1969 IV, 1970 IV	1.6	4.4	[2] 5.2
Unit labor costs:			
1948 IV, 1949 IV	−2.6	−.8	6.3
1953 II, 1954 III	.8	1.6	6.4
1957 III, 1958 II	1.6	.3	2.8
1960 II, 1961 I	1.7	−1.9	.3
1969 IV, 1970 IV	5.2	2.7	[2] 1.2

[1] Peak and trough quarters are those designated as cyclical turning points by the National Bureau of Economic Research.
[2] Preliminary.
[3] Output per man-hour.

Note.—Data relate to all persons.

Source: Department of Labor, Bureau of Labor Statistics (except as noted).

to decline around the trough quarter. In contrast, during the early stages of the recovery from the 1970 recession, the rise in unit labor costs, although down from earlier rates, remained high. However, because of the acceleration in productivity growth since the third quarter of 1971, and the slowdown in compensation increases, unit labor costs have increased little. During the comparable phase of previous expansions, unit labor costs have usually risen substantially relative to their behavior during the early recovery phase.

NONFINANCIAL CORPORATIONS

A comprehensive set of figures on output, prices, and costs is available for the important nonfinancial corporate sector. These data provide a convenient accounting framework for a detailed discussion of prices, costs, and profits.

In general the behavior of costs and prices in the corporate sector is not very different from that of the broader private nonfarm sector just reviewed. From the third quarter of 1971 to the third quarter of 1972, the rate of inflation for nonfinancial corporations slowed to 1.3 percent from the rate of approximately 4 percent experienced in the 2 preceding years (Table 10). Over the same period, the rise in unit labor costs, which had already started to abate the year before, fell to an annual rate of less than 1 percent—a joint reflection of both a stepping up in the rise in productivity to 5.0 percent per

TABLE 10.—*Changes in prices, costs, and profits per unit of output for nonfinancial corporations, 1967 III to 1972 III*

Item	1967 III to 1968 III	1968 III to 1969 III	1969 III to 1970 III	1970 III to 1971 III	1971 III to 1972 III
Dollar change per unit of output:					
Price	0.029	0.030	0.044	0.048	0.016
Employee compensation	.020	.038	.045	.022	.008
Other costs	.008	.016	.022	.017	.001
Capital consumption allowances	.001	.007	.008	.010	.003
Indirect business taxes [1]	.005	.004	.008	.006	−.001
Net interest	.002	.005	.006	.001	−.001
Profits [2]	.002	−.024	−.022	.007	.008
Percent change per unit of output:					
Price	2.6	2.6	3.8	4.0	1.3
Employee compensation	2.8	5.2	5.9	2.7	1.0
Compensation per man-hour	7.3	7.2	7.9	6.8	5.8
Output per man-hour	4.4	1.8	2.0	4.0	5.0
Other costs	3.4	6.7	8.6	6.1	.3
Capital consumption allowances	.9	6.4	6.9	8.1	2.2
Indirect business taxes [1]	5.0	3.8	7.3	5.1	−.8
Net interest	8.7	20.0	20.0	2.8	−2.7
Profits [2]	1.2	−14.4	−15.4	5.8	6.3
Percent change in output	7.0	4.4	−1.4	1.8	9.2

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

Note.—Detail may not add to totals because of rounding.

Sources: Department of Commerce, Bureau of Economic Analysis, and Department of Labor, Bureau of Labor Statistics.

annum and a slowdown in the rise of hourly compensation to 5.8 percent per annum. The rise in hourly compensation in 1972 was the smallest year-to-year rise experienced since 1967 and the rise in productivity the highest since 1965.

All other unit costs combined, which include capital consumption charges, indirect taxes, and interest, were essentially unchanged from the third quarter of 1971 to the corresponding quarter of 1972. Lower interest costs and indirect business taxes per unit of output offset an increase in capital consumption costs per unit. Since the percentage increases in aggregate dollar costs of each of these categories over the past year were about the same as in the preceding year, the improved behavior in costs per unit was essentially a reflection of the acceleration of the rise in output. Had the liberalized depreciation regulations not been in effect, capital consumption costs per unit would have been virtually unchanged during the year instead of rising 2 percent. Profits before taxes would have been correspondingly higher. It is also interesting to note that the recent decline in interest costs per unit of output followed a modest increase in the preceding year and dramatic increases in 1969 and 1970, when interest rates were at their peaks.

Profits per unit of output rose 6.3 percent (before tax and including the inventory valuation adjustment) over the past year. The most recent rise followed a 5.8-percent increase the year before and a net decrease of nearly 30 percent over the preceding 2 years. The peak for profits per unit of output was reached in the fourth quarter of 1965; almost 7 years later they were still some 25 percent lower.

Rising profit margins and increased physical volume raised total before-tax profits of nonfinancial corporations by 14 percent from 1971 to 1972. Even so, the rise in corporate profits in the most recent expansion has not been large compared to experience in previous recoveries. As Table 11 shows, the rise in profits relative to the rise in corporate output (for the nonfinancial corporate sector) has been smaller over the first 7 quarters

TABLE 11.—*Changes in gross product and profits before taxes of nonfinancial corporations 7 quarters after trough and ratio of changes*

Trough [1]	Change 7 quarters after trough (billions of dollars)		Change in profits as percent of change in gross product
	Gross product	Profits [2]	
1949 IV	45.5	13.4	29.5
1954 III	38.7	7.0	18.1
1958 II	47.7	13.5	28.3
1961 I	42.3	11.4	27.0
1970 IV	94.7	19.1	20.2

[1] Quarters designated as trough by the National Bureau of Economic Research.
[2] Before taxes and including inventory valuation adjustment.

Source: Department of Commerce, Bureau of Economic Analysis (except as noted).

of the present recovery than during corresponding periods of earlier recoveries in all but one instance. Furthermore, the rise in profits in the present expansion is itself biased upward because profits in the fourth quarter of 1970 (the trough from which the expansion is measured) were depressed by the General Motors strike.

Profit Shares

Because profits rose more and employee compensation rose a bit less than the 10-percent overall rise in the gross product of nonfinancial corporations, the share of profits rose from 10.2 percent in 1971 to 10.6 percent in 1972, while the share of employee compensation fell from 66.4 to 66.2 percent (Table 12). A similar shift, which is typical during cyclical upturns, occurred between 1970 and 1971. However, in 1970 the profit share of

TABLE 12.—*Distribution of gross product originating in nonfinancial corporations, 1947–72*

[Percent[1]]

Period	Total	Compensation of employees	All other costs				Profits[3]
			Total	Capital consumption allowances	Indirect business taxes[2]	Net interest	
1947	100.0	65.9	14.8	4.8	9.3	0.7	19.4
1948	100.0	63.9	14.5	5.0	8.8	.7	21.6
1949	100.0	63.8	16.1	5.9	9.5	.8	20.1
1950	100.0	62.4	15.5	5.7	9.2	.6	22.1
1951	100.0	63.1	15.1	5.8	8.7	.6	21.7
1952	100.0	64.8	16.1	6.2	9.2	.7	19.1
1953	100.0	65.9	16.6	6.6	9.3	.7	17.4
1954	100.0	65.9	17.6	7.7	9.1	.8	16.6
1955	100.0	63.9	17.5	7.9	8.9	.7	18.6
1956	100.0	65.3	17.7	8.0	9.0	.7	16.9
1957	100.0	65.6	18.6	8.4	9.3	.9	15.8
1958	100.0	65.9	19.9	9.1	9.7	1.1	14.2
1959	100.0	64.7	19.1	8.7	9.3	1.0	16.2
1960	100.0	65.5	19.7	8.9	9.7	1.1	14.8
1961	100.0	65.1	20.4	9.2	9.9	1.3	14.5
1962	100.0	64.3	20.8	9.7	9.8	1.4	14.9
1963	100.0	63.9	20.9	9.7	9.8	1.4	15.2
1964	100.0	63.3	20.8	9.5	9.8	1.5	16.0
1965	100.0	62.6	20.4	9.4	9.5	1.6	17.0
1966	100.0	63.2	20.0	9.3	8.9	1.8	16.8
1967	100.0	64.0	20.9	9.7	9.1	2.1	15.1
1968	100.0	64.2	21.2	9.7	9.3	2.2	14.7
1969	100.0	65.7	21.8	9.9	9.3	2.5	12.5
1970	100.0	67.2	23.0	10.3	9.7	2.9	9.8
1971	100.0	66.4	23.4	10.6	9.9	2.9	10.2
1972[4]	100.0	66.2	23.2	10.7	9.6	2.9	10.6
1971: I	100.0	66.5	23.2	10.3	9.9	2.9	10.3
II	100.0	66.4	23.1	10.4	9.8	2.9	10.5
III	100.0	66.3	23.5	10.6	9.9	3.0	10.2
IV	100.0	66.4	23.7	10.8	10.0	3.0	9.9
1972: I	100.0	66.4	23.2	10.7	9.7	2.9	10.3
II	100.0	66.2	23.3	10.9	9.6	2.9	10.5
III	100.0	66.1	23.2	10.7	9.6	2.9	10.7

[1] Quarterly percents based on seasonally adjusted data.
[2] Also includes business transfer payments less subsidies.
[3] Before taxes and including inventory valuation adjustment.
[4] Preliminary.

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce, Bureau of Economic Analysis.

corporate output was at its postwar low and the compensation share at its postwar high. The relative shift that has occurred over the past 2 years in favor of profits still leaves the profit share lower and the employee compensation share higher than in any postwar year before 1970.

Long-range comparisons of the profits share, including those just cited, suffer from the fact that over the years depreciation laws and regulations have undergone many changes that affect the calculation of profits. This shortcoming can be overcome through the use of uniform methods of calculating depreciation over time, so that the resultant estimates of profits are not affected by changes in depreciation practices.

The Commerce Department has made such calculations, and the results are shown in the second column of Table 13. The adjustment raises the profits share for most of the periods (it is lowered for the 1950–54 period), but in terms of changes over long periods the picture shown by the unadjusted numbers (column 1 of Table 13) is not altered in any significant way. Comparisons should properly be made only between periods in comparable stages of the business cycle; but even if one focuses on a year like 1968, when economic activity was high and unemployment was very low, it is clear that the profits share has declined in comparison with earlier periods (Chart 5).

A final adjustment should take account of interest, which is part of the total return on capital and which has grown in importance over the post-World War II period, as corporations have placed greater reliance on debt as opposed to equity financing and as interest rates have risen more rapidly than the price of corporate output. The share of interest plus adjusted profits in gross corporate output has also declined over the long run, but that decline has been milder than for adjusted profits alone.

TABLE 13.—*Profits before adjustment, adjusted profits, and interest as shares of gross product of nonfinancial corporations, 1950–72*

[Percent]

Period	Profits before adjustment	Adjusted profits [1]	Interest	Adjusted profits plus interest
1950–54 average	19.4	18.4	0.7	19.1
1955–59 average	16.3	16.6	.9	17.5
1960–64 average	15.1	15.6	1.3	16.9
1965–69 average	15.2	15.5	2.0	17.5
1968	14.7	14.9	2.2	17.1
1969	12.5	12.8	2.5	15.3
1970	9.8	10.0	2.9	12.9
1971	10.2	10.5	2.9	13.4
1972 [2]	10.6	[3] 11.0	2.9	13.9

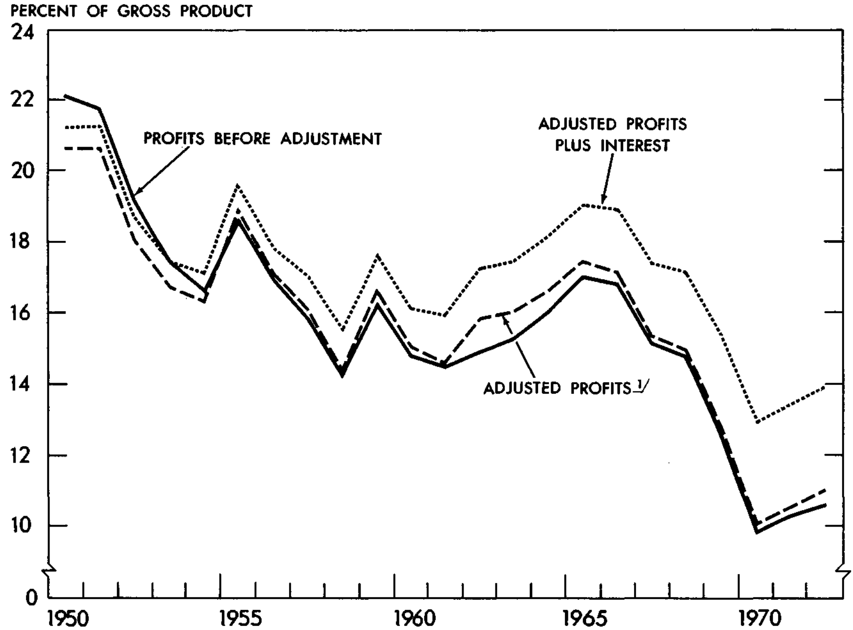
[1] Based on uniform method of calculating depreciation: historical cost valuation of assets, double declining balance and service lives equal to 85 percent of those shown in Treasury Bulletin F.
[2] Preliminary.
[3] Estimate by Council of Economic Advisers.

Note.—All profits are before taxes and include inventory valuation adjustment.
Profits in this table exclude those on residential properties owned by nonfinancial corporations and therefore differ from those shown in Table 12.

Source: Department of Commerce, Bureau of Economic Analysis (except as noted).

Chart 5

Shares of Profits and Interest in Gross Product of Nonfinancial Corporations



1/ SEE TABLE 13 FOR DEFINITION.
NOTE: ALL PROFITS ARE BEFORE TAXES AND INCLUDE INVENTORY VALUATION ADJUSTMENT.
SOURCE: DEPARTMENT OF COMMERCE.

FARM PRICES AND RURAL INCOMES

Rising domestic and export demand and reduced supplies as a result of lower net farm production brought sharply higher prices and incomes to rural families in 1972. Prices received by farmers rose 18 percent from December 1971 to December 1972.

International events had a significant effect on prices. Reduced food production in three major countries—Russia, China, and India—expanded the demand for food grains from U.S. farms. The expansion in demand brought a quick response in prices of farm commodities, as is typical of products with a relatively inelastic demand and a very inelastic short-run production. Because the United States was the only major food-exporting nation with large carryover supplies of wheat and other grains, this country was in a very favorable position to expand its exports of farm commodities in 1972. The volume of farm exports increased nearly 14 percent, and exports of food commodities advanced 17.5 percent.

Changes in domestic economic conditions also improved farm incomes last year. As nonfarm employment and income rose, demand for income-elastic food items strengthened, causing a strain on the available supply of beef, pork, and certain dairy products. The result was rising farm and retail prices. Even the removal of restraints on meat imports and the resulting increase in imports of lean meat left domestic meat prices at all-time record levels. Only in the autumn did red meat prices show some moderation, mainly because of expanded marketings of beef animals and diversion of purchases to other meats for the holiday periods.

While demand was expanding in 1972, overall net farm output including food and nonfood commodities remained quite static. Indeed domestic production of food commodities actually dropped 2.2 percent below the previous year, according to preliminary estimates. Unseasonable weather and storms hit several parts of the country at critical times and cut back fruit and vegetable production sharply. Pork output reached a low phase in the production cycle, and beef production rose less than anticipated, partly because favorable prices caused more stock to be retained for expansion of herds.

While family income in the nonfarm sector was also rising substantially, the agricultural gains were so large that farm families improved their relative position. Net farm income reached $19 billion for the year, up $3 billion, or 18 percent, from 1971 and well above the previous all-time high of $17.1 billion earned in 1947. With only half as many families on farms today as there were 25 years ago, income per family is much higher.

Along with the sharp improvement in farm income in 1972, rural families also benefited from the expansion of the general economy. For a large proportion of farm families, the increase in employment and the rise in nonfarm wages were more important than the change in farm prices, since over half of all farm families earn the greater part of their income from nonfarm sources. Most of these farm operations are small, grossing less than $5,000 a year from farm sales. In fact, over 85 percent of the annual income among this group is earned off the farm, and income improvements from farm prices or Government farm programs thus directly affect only about 15 percent of their income. This situation is not limited, however, to only the smallest farms. Even the operators of the largest farms, those classified as having sales over $40,000, earn about one-fifth of their total income from off-farm sources.

FISCAL POLICY IN 1972

Fiscal policy was deliberately expansionary in 1972. The stimulus came from rising expenditures and from the effect of tax reductions instituted in 1971 and 1972. On a national income accounts basis, full-employment revenues in calendar 1971 exceeded full-employment expenditures by $1 billion. The corresponding figure for calendar 1972 was a full-employment deficit of $4 billion—a swing of some $5 billion. These estimates understate the size of the swing and of the stimulus provided by fiscal policy, because 1972 receipts include about $9 billion in overwithheld personal income taxes. As discussed below, consumer behavior is probably less sensitive to the temporary cash effects of overwithholding than it is to a more permanent change in income. If Federal receipts from overwithholding are entirely excluded, the estimated full-employment deficit in 1972 is $13 billion—a swing of $14 billion from the position in 1971. On net balance, the stimulus from budget policy in 1972 was somewhere between $5 billion and $14 billion and probably closer to the higher end of this range.

The policy shift set forth in August 1971 assigned little importance to increased Government spending as such. On the contrary, the program envisaged some cutbacks in Federal employment and a postponement of a Government pay raise. It sought instead to stimulate private spending through tax incentives for investment, repeal of the excise tax on motor vehicles, and an acceleration of the scheduled date for personal income tax reductions.

As originally proposed in its two-tier form, the job development tax credit was expected to have a large and immediate impact on capital goods demand and output. The excise tax cut was expected to stimulate demand for and production of motor vehicles. These tax measures, along with the anticipated change in public sentiment resulting from the policy shift, strengthened the sluggish recovery that was underway. Industrial production rose after August and the rate of growth in real GNP accelerated in the fourth quarter. However, the unemployment rate, which had risen to 6 percent around the beginning of 1971, stayed at that level with only minor variation until the end of the year. Consequently, in presenting its plans for fiscal 1973 the Administration indicated that it would take additional steps to stimulate the economy by raising the level of expenditures during the remaining half of fiscal 1972. At the same time, the Administration emphasized its intention to restrain the growth in expenditures starting in fiscal 1973. The Administration's position was that the total stimulus provided would be sufficient to accelerate the recovery, but that further stimulus might threaten the anti-inflation program.

FEDERAL EXPENDITURES

According to the budget data presented in January 1972, total expenditures (NIA basis) were projected to rise by $29 billion or 13 percent from calendar 1971 to calendar 1972, a sharp advance by historical standards. Actual expenditures rose by 12 percent (Table 14).

Included in this projected rise was an increase of $9 billion in Federal purchases, which embraced a scheduled $5.2 billion pay increase for military and civilian personnel and a step-up in real purchases. The latter was an extension of a turnaround that had begun in the second half of 1971, following the prolonged and steep decline in defense purchases associated with the process of disengagement in Vietnam. Actual 1972 purchases fell a bit short, basically in the second half.

In addition to the planned increase in purchases, the budget called for a rise of one-sixth in other types of outlays. This rise included $5.2 billion for revenue sharing, and provision for a 5-percent increase and some liberalization of social security benefits at an estimated annual cost of $3½ billion starting in the third quarter of 1972. Because revenue sharing legislation was delayed, the actual transfer of 1972 grant funds was later scheduled to take place in two instalments payable in December 1972 and in January 1973. In addition Congress altered the Administration's social security proposal by providing a 20-percent increase starting in the fourth quarter of 1972 at an estimated annual cost of $8 billion.

TABLE 14.—*Federal Government receipts and expenditures, national income accounts basis, calendar years, 1971–72*

[Billions of dollars]

Receipts and expenditures categories	1971	1972	
		January 1972 budget projection [1]	Actual [2]
Federal Government receipts	199.1	215.6	228.3
Personal tax and nontax payments	89.6	94.1	108.8
Corporate profits tax accruals	33.1	36.1	36.0
Indirect business tax and nontax accruals	20.5	20.5	20.1
Contributions for social insurance	55.9	65.1	63.3
Federal Government expenditures	220.8	249.5	246.8
Purchases of goods and services	97.8	107.1	105.9
Defense	71.4	75.9	76.2
Other	26.3	31.1	29.7
Transfer payments	75.0	82.8	83.5
Grants-in-aid to State and local governments	29.3	39.8	37.7
Net interest paid	13.6	13.3	13.6
Subsidies less current surplus of government enterprises	5.2	7.0	6.1
Surplus or deficit (—) on income and product accounts	−21.7	−33.9	−18.5

[1] January 1972 projected percent changes applied to revised 1971 actual data.
[2] Preliminary.

Note.—Detail may not add to totals because of rounding.

Sources: Department of Commerce, Bureau of Economic Analysis, and Office of Management and Budget.

FEDERAL RECEIPTS

Budget changes on the revenue side in last January's budget presentation reflected the tax proposals of August 1971, as extended and modified by the Congress, as well as proposals made before August 1971. In addition, the Administration proposed that the social security taxable earnings base be raised from $9,000 to $10,200, to take effect at the start of 1972. This increase was subsequently amended and deferred to 1973 by congressional action taken in October.

Planned tax reductions affecting revenues in 1972 included some features already mentioned: the job development tax credit, the repeal of the excise tax on motor vehicles, and an advance in the effective date of the rise (to $750) in personal exemptions. Other revenue reductions included a retroactive rise in personal exemptions from $650 to $675, applicable to 1971 incomes, an increase in the minimum standard deduction to $1,300 per return, and a 1-year speedup in the effective date of a scheduled rise in the standard deduction from 14 to 15 percent. Revenue-increasing features included a rise from earlier legislation in the taxable social security wage base from $7,800 to $9,000, the proposed further rise to $10,200, and the elimination of certain features of the revised depreciation regulations.

The estimated net effect of the proposed tax changes, in themselves, was to reduce calendar year 1972 revenues by about $4 billion relative to 1971 in NIA terms. Although on this basis tax increases and tax reductions for individuals appeared to be approximately offsetting, on balance these proposed changes provided some net fiscal stimulus in calendar 1972. Under the NIA procedures that are used to seasonally adjust contributions for social insurance, increases in receipts from a rise in the taxable earnings base begin at the full annual rate in the first quarter, even though the required additional taxes are ordinarily not paid until the second half of the year.

With these proposed tax changes providing a partial offset to the rise in revenues expected from the rise in economic activity and incomes, Federal receipts were expected to show a fairly steady increase during calendar 1972 and to total $215½ billion. In fact, receipts turned out to be some $12½ billion higher than anticipated. Part of this difference reflected a faster rise in tax accruals than had been foreseen for 1972, but the greater portion derived from the fact that personal income tax receipts were considerably in excess of projections because of the overwithholding that began early in 1972.

The origin of overwithholding goes back to 1971, when families with more than one source of wage and salary income had withholdings that fell short of their liabilities. The withholding tax table for 1972 was particularly designed to correct the 1971 experience for such families and was generally meant to allow all taxpayers to bring their withheld taxes closer to their liabilities. However, under these schedules single individuals and families with only one source of wage or salary income had to claim additional exemptions if they were to avoid overwithholding. For the most part, single-income families did not take advantage of the option to adjust their withheld taxes downward. Withholdings have consequently been running considerably in excess of liabilities and will result in substantial refunds in 1973.

How the effect of overwithholding should be treated for purposes of analysis depends on a prior view of how it affects consumer spending. According to one view, known as the permanent-income hypothesis, consumer spending is governed largely by consumers' views of their permanent or longer-run incomes; temporary aberrations in income do not alter spending significantly. Consequently, overwithholding and the subsequent associated refunds should not have a large effect on the pattern of consumer spending. In this view, which has some support on the basis of consumer behavior in 1972, most of the effect of overwithholding and of the subsequent refunds should be excluded—from the calculation of the full-employment surplus or deficit, for example—for purposes of analysis. According to another view most consumers govern their spending according to the income immediately available to them, regardless of whether the income is permanent or temporary. Clearly, a definitive answer must await an examination of how consumers behave in 1973 after they receive refunds on last year's overwithholding.

THE REQUEST FOR A SPENDING CEILING

The increase in outlays in 1972, especially in the first half of the year, served the purpose of stimulating the economy: by midyear the expansion, as expected, had developed a strong momentum of its own. For the period after mid-1972, the emphasis of budget policy has been on restraining the growth in expenditures. In June, the Administration requested Congress to impose a statutory ceiling of $246 billion on unified budget outlays for fiscal 1973—an amount equal to the original spending total proposed last January.

The shift of 1972 revenue sharing payments to late calendar year 1972 and early 1973, and the large increase in social security benefits late in 1972, had a relatively small effect on the level of spending budgeted for calendar 1972. However, both changes raised the level of expenditures for fiscal 1973 significantly above the amount originally proposed.

Anticipation of these developments heightened concern about not only the level and growth of Federal spending but the potential danger to the anti-inflationary program and the orderliness of the economic expansion. In September, the Administration repeated its request for a statutory ceiling on fiscal 1973 outlays, this time at the $250 billion level. Although both the House and Senate voted favorably on the ceiling—in bills of different form—final congressional approval was not obtained.

STATE AND LOCAL GOVERNMENTS

State and local government purchases rose by 10 percent from 1971 to 1972, a rise somewhat below that projected by the Council at the start of the year. The shortfall was partly due to the delay in revenue sharing; but this factor should not be overstressed, because the relation between Federal grants and State and local spending is neither direct nor immediate. Initially, at least, increased Federal grants appear as increases in State and local surpluses.

The $5.2 billion revenue sharing bill, originally scheduled for the first quarter of 1972, was passed in October. The first payment for 1972 was made retroactively in December, when a half-year's instalment of $2.62 billion (recorded in the national income accounts at an annual rate of $10.5 billion in the fourth quarter) was mailed out to States and localities. The remaining half-year instalment was mailed in January 1973. In April 1973 the payments are scheduled to revert to an annual rate of $6.0 billion payable quarterly.

The beginning of revenue sharing in the fourth quarter has increased the level of Federal grants and the likelihood that State and local governments will continue to run large surpluses for a time in NIA terms. With the level of Federal grants now increased by the advent of revenue sharing and with the growing importance of State and local government spending, the behavior of the revenues and expenditures of State and local governments assumes much greater importance in the assessment of the effects of Federal fiscal policy.

FINANCIAL POLICY AND FINANCIAL MARKETS

Although the financial requirements of last year's expansion were considerable, they were generally accommodated in a satisfactory fashion. The large demand for funds was accompanied by remarkably mild increases in short-term interest rates. Long-term rates on balance actually declined. The money supply expanded by 8.2 percent over the year (December to December), clearly less than the expansion of 10.9 percent in nominal GNP. Housing and mortgage markets enjoyed a record year with a reduced need for Federal assistance.

MONETARY POLICY

Federal Reserve goals in 1972 were "sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments." Throughout the year Federal Reserve efforts were directed toward establishing financial market conditions conducive to these goals.

Monetary expansion in the fourth quarter of 1971 had been unusually slow: the seasonally adjusted annual rate of growth (measured from the final month of the third quarter to the final month of the fourth quarter) was 1.1 percent. The rate was low historically and below the Federal Reserve's target rate. As a result of this shortfall and the requirements of the ongoing economic expansion, the Federal Reserve moved to increase the rate of monetary growth in the first quarter of 1972. To help achieve this objective the System acted to ease credit market conditions. At the same time, in the execution of policy it gave increased emphasis to the growth in bank reserves by means of a new reserve concept: reserves available to support private nonbank deposits (RPD's). The adoption of this additional target for daily operations was taken partly because of the difficulty the System had experienced in 1971 in controlling the monetary growth rate by influencing the Federal funds rate. While the monetary growth rate remained the intermediate target for policy, day-to-day operations were carried out in terms of an RPD guide range as well as money market conditions.

In the first quarter of 1972 the rate of growth in the narrowly defined money stock rose to 9.6 percent per annum. Since this was a somewhat faster rate than the Federal Reserve had expected, operating policy sought to restrain monetary growth and to allow market interest rates to rise. This posture was maintained through the summer and early autumn; the

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target for the rise in RPD's was gradually reduced from a range of 9 to 13 percent for March–April to a 3- to 7-percent range for July–August.

In the third quarter, the continuation of strong economic expansion increased the quantity of money demanded and pressed the cost of credit upward. Since excessive monetary accommodation would have had serious implications for future inflation, the Federal Reserve sought only "moderate" growth in the monetary aggregates. For the third quarter, RPD's rose at a 10.3-percent rate, while the monetary growth rate increased to 8.7 percent from 5.4 percent in the second. Short-term market interest rates rose gradually, as indicated by the increase in the Federal funds rate from an average of 4.46 percent in June to 4.87 percent in September.

Late in the third quarter and early in the fourth, a policy of somewhat more restraint was adopted, but the conduct of monetary policy was complicated in the fourth quarter by changes in Federal Reserve Regulations D and J. These changes restructured reserve requirements according to bank size and speeded the payment of checks. Both shifts radically altered the volume of reserves which banks desired and accumulated, and monetary policy necessarily proceeded cautiously to allow the banking system to adjust to the new regulations without influencing monetary aggregates or financial markets. Short rates rose further during the quarter, with the rate for Federal funds increasing to 5.33 percent in December. Nevertheless the rate of monetary growth accelerated.

One of the advantages of the shift in policy emphasis to an RPD target is that this procedure improves control over the monetary growth rate and protects the economy against fluctuations that might take place if only an interest rate target is used. Although other considerations also affected the formulation of policy in 1972, the adoption of the new procedures appears to have had a stabilizing effect on monetary growth. While the money stock grew by 8.2 percent from December 1971 to December 1972—up from 6.2 percent in 1971 and 5.4 percent in 1970—its behavior was smoother during 1972 than in the 2 preceding years. For example, the quarterly growth rate ranged from 5.4 to 9.6 percent in 1972 as compared to a range of 1.1 to 11.0 percent in 1971.

Although the monetary growth rate over the course of 1972 was lower than the corresponding rise in real GNP, it was still the second highest of the post-World War II period. As is usually the case, assets which are close substitutes for money grew even faster than the money stock during 1972. Regular time deposits at banks rose by 13 percent during the year, while accounts of nonbank thrift institutions increased by 17 percent. Large negotiable bank certificates of deposits rose by 31 percent for the year. As in 1971, the rates paid by thrift institutions on deposits were higher relative to open market rates than was the case in 1969 and 1970, and this was a factor contributing to heavy deposit inflows.

INTEREST RATES

A notable financial development in 1972 was the relatively stable behavior of interest rates. Long-term interest rates followed a generally downward course for the year and short-term rates rose moderately, even though many observers had anticipated that both rates would increase sharply in response to the credit requirements of a strong economic expansion (Chart 6). The unusually wide spread between short- and long-term rates that prevailed at the beginning of 1972 narrowed in the course of the year but remained historically large at yearend.

Short-term market interest rates declined in January and February and followed a generally upward path for the remainder of the year, the rise being interrupted by temporary declines in May and August. Commercial banks' prime rates, which are generally closely related to market rates, also rose over the year. The upward pressure on short-term rates reflected the underlying growth of the economy as a whole and the increasing demands made on credit markets to support the expansion. The increase in short-term rates was considerably milder, however, than increases experienced at the same stage of past economic upturns.

Long-term market rates declined on balance over 1972. They rose through April but thereafter fluctuated below April peaks on a generally downward trend. The declining trend of long-term rates at the same time that short-term rates rose was an interesting feature of 1972. While short and long rates can move in opposite directions (if, for example, there is a sharp change in expectations about levels of future interest rates) historically short and long rates have tended to move in the same direction. Several forces produced this divergence in 1972.

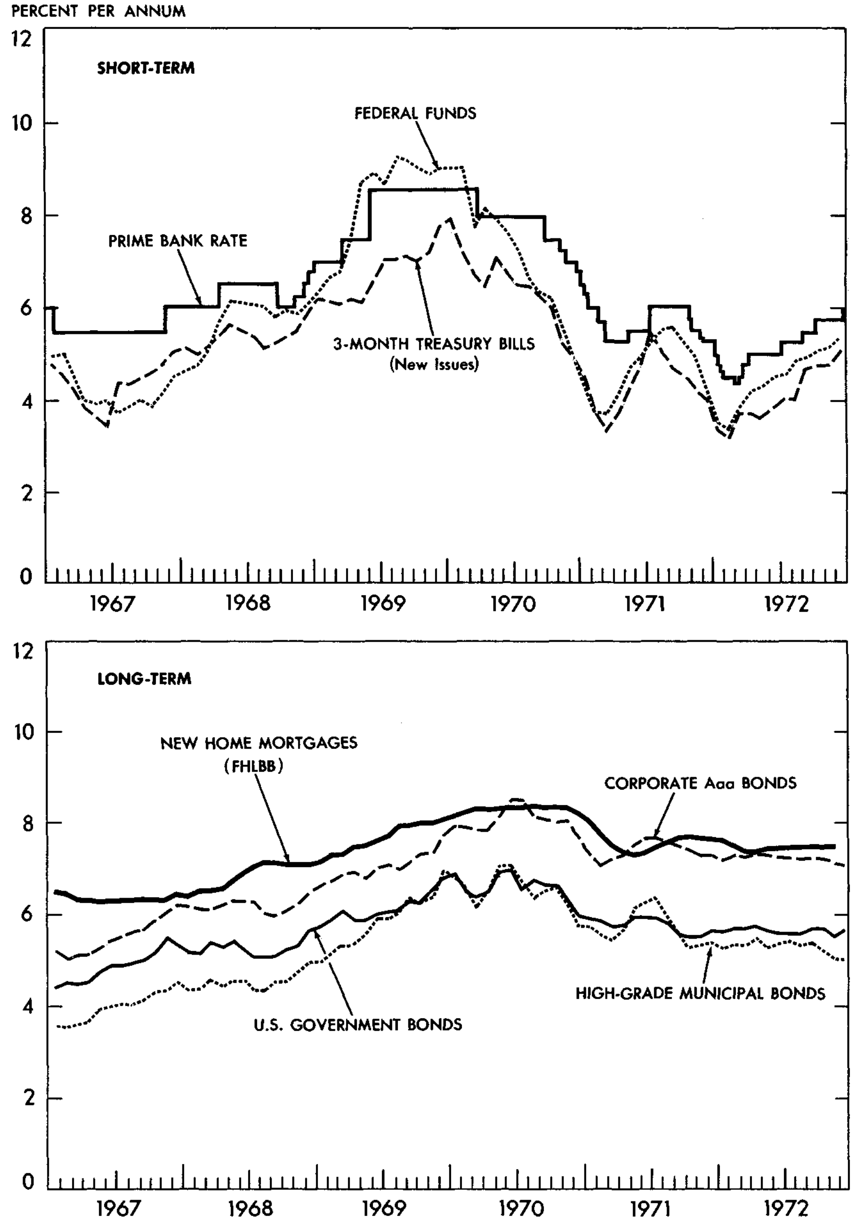
First, at least two factors probably led investors to be less desirous of holding funds in highly liquid forms: increasing certainty about the strength of the economic expansion in 1972, and less uncertainty about the effects of controls on wages and prices.

Second, foreign central banks slowed the pace at which they bought short-term Treasury securities with the dollars accumulated through their balance-of-payments surpluses. This reduction resulted from both a slowing of the dollar outflow from the United States and a shift in preferences of foreign official institutions toward obligations with longer maturities, especially after it became clear that the flow of dollars back into the United States following the Smithsonian Agreement in December 1971 was smaller than had been expected earlier.

Third, the downward revision of expectations of future inflation seems to have extended to longer horizons in 1972, causing estimates of long rates to be lowered. (See Chapter 2.) In addition, the levels of real interest rates expected in the future may have been reduced as it became evident that the rise in actual rates in 1972 was much milder than had been widely anticipated.

Chart 6

Interest Rates



SOURCES: TREASURY DEPARTMENT, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL HOME LOAN BANK BOARD, MOODY'S INVESTORS SERVICE, AND STANDARD & POOR'S CORPORATION.

Mortgage Interest Rates

Mortgage interest rates, which had followed a downward trend in late 1971, continued to decline in early 1972. They reached their lows for the year in April and moved up slightly thereafter, even though other long rates continued to edge down. The increases in mortgage rates have been small: from April to November, the contract rate on conventional mortgages for new homes rose from 7.38 to 7.50 percent, still below the 7.68-percent level of October 1971 and well below the rates that prevailed for all of 1970.

Assistance to Mortgage Markets

The mortgage and housing markets in 1972 enjoyed a prosperous year with considerably less support from Federal agencies than in previous years. There was less upward pressure on all interest rates than in past years. Partly as a consequence of this, there was a strong inflow of funds to financial intermediaries, particularly savings and loan associations and mutual savings banks. As in 1971, these institutions, which lend the bulk of their funds on residential mortgages, added to their mortgage holdings on a larger scale than in previous years.

The program of the Government National Mortgage Association (GNMA) for reducing discounts on federally insured mortgage loans—the "tandem plan"—was largely dormant during the year because the decline in market rates lowered those discounts to support levels. However, GNMA continued to develop and expand its 3-year-old mortgage-backed securities program, which is designed to attract new funds for housing finance by increasing the ability of residential borrowers to compete in the general capital market. The issuance of GNMA securities increased to $3.6 billion in 1972, as compared to $3.0 billion in 1971.

The Federal National Mortgage Association (FNMA) was also a steady purchaser of FHA- and VA-insured mortgages over the year, although on a smaller scale than in 1970 and 1971. For 1972, FNMA's net acquisition of mortgages was $2.0 billion, compared with $4.4 and $2.4 billion in 1970 and 1971, respectively. The Federal Home Loan Mortgage Corporation purchased $1.3 billion in conventional and insured mortgages as against $0.8 billion in 1971.

The Federal Home Loan Bank Board also took a number of steps toward strengthening the ability of savings and loan associations to compete for funds as a means of increasing the flow of funds into the mortgage market. These steps included: (1) An increase from $30,000 to $36,000 in the maximum loan limit on 95-percent conventional loans of Federal associations, (2) an increase from 5 to 10 percent in the fraction of total loans that Federal associations can hold in the form of mobile home loans, and (3) approval of the issuance of subordinated debt instruments of 7 years or longer maturity by savings and loan associations as a new source of funds. It also proposed regulations for variable rate mortgages for federally chartered associations.

FOURTH QUARTER DEVELOPMENTS

The year 1972 ended with considerable forward momentum in economic activity. According to preliminary fourth quarter data, GNP rose by \$32 billion, or at a seasonally adjusted annual rate of 11½ percent. The rise in real terms was 8½ percent, and the price rise as measured by the GNP deflator 2¾ percent. Judging from monthly indicators such as industrial production, the course of output was strongly upward through the quarter.

All major components, except for Federal purchases of goods and services, contributed to the large fourth-quarter rise in demand. Consumer spending was exceptionally strong, rising by \$17½ billion. Underlying the strength of consumer demand was a sharp rise in payrolls, which reflected rising employment and a longer workweek, notably in the manufacturing sector. In addition, the increase in earned income was supplemented by the enlarged payments of social security benefits that had begun in October. Total retail sales in December were 11½ percent above the level of December 1971. Fixed investment also rose substantially in the final quarter, and it appeared that businessmen were stepping up their rate of inventory accumulation in order to accommodate the increased volume of sales.

Civilian employment rose by 525,000 during the quarter to a total of 82.8 million in December, about 3 percent above the level of a year earlier. The unemployment rate declined to 5.1 percent in December, compared to a rate of 6.0 percent in December 1971. All major age and sex groups were affected by the decline in unemployment, but the reduction was especially marked for adult males in the prime working-age bracket.

Price performance was mixed. From September to December the CPI rose at a seasonally adjusted annual rate of 3.2 percent, or 2.5 percent excluding food. The WPI showed an extraordinary increase (9.6 percent annual rate) because of sharp rises in farm and food prices; in contrast, the rise in wholesale industrial prices was only 2 percent. The pronounced increases in farm and food prices, which posed a serious threat to the entire stabilization program, led to new policy initiatives at the start of 1973.

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 his assessment of the progress attained in achieving the purposes of this title." This chapter and the supplement included in Appendix A of this *Report* are intended to fulfill that requirement. There is, however, no intent to represent the description of the control regulations contained herein as legally binding interpretations.

THE UNITED STATES has had general price and wage controls before, during both World War II and the Korean war. But 1972 marked the first full year in American history that comprehensive wage and price controls were in effect when the economy was not dominated by war or its immediate aftermath. Judged by any expectations one could derive from history, either in the United States or abroad, the system was successful. Nevertheless, by the end of the year it was plain that although continuing controls could make a further contribution to economic stabilization, the system would have to be modified. As the year ended the Administration was developing a revision of the system that would make its operation more effective and at the same time lay the groundwork for its termination.

THE SITUATION IN AUGUST 1971

To understand what is meant by the "success" of the controls one must go back to the conditions which existed in the summer of 1971. By then the rate of inflation had declined from its 1969 peak, and output and employment were expanding. Neither the decline in the inflation rate nor the expansion of the economy had been as marked as people had hoped for or as the Administration had forecast. A more rapid expansion and a further slowdown of inflation in the months ahead were high on the list of the Nation's goals.

The true probabilities for the future behavior of the economy—as distinguished from what people thought might happen—were not known. However there were several reasons why the rate of inflation might still continue to decline after August 1971. First, prices and wages would be responding, with a lag, to the slowdown in the economy that had occurred earlier. Second, the prospective recovery of the economy, even according to an optimistic view of its pace, would still leave the economy in a situation of excess capacity rather than excess demand throughout 1972. Third, more rapid recovery would accelerate the rise of productivity and hold down the rise of unit costs.

On the other hand, there were reasons why the inflation rate, which had been declining since 1969, might not only stop falling but might accelerate. For one thing, the decline might already have ended. The *Economic Report* of 1972 summarized the evidence of the price indexes at mid-1971:

> (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.*

By August 1971 the recovery of the economy was in its ninth month. At that point in earlier recoveries the rate of inflation had begun to accelerate, rather than continue to decelerate. This might have happened again after August 1971: inflationary expectations and the effort of some workers to catch up with the cost of living and with the wage increases of other workers had not been eliminated during the period of economic slowdown. Such price-raising forces might have been suppressed only to break out again when the pressure of deficient demand was relaxed. Indeed, as workers and businessmen became more aware of the continued expansion, especially expansion produced by Government action, their belief that rapid inflation was inevitable would be reinforced and might even tend to generate the feared result.

Although the feared acceleration of inflation was associated with the prospect of economic expansion, it should be clear that the price rises then envisaged for the period ahead would not be the direct result of excess demand. The price and wage increases would not be equilibrating in the sense that they would be necessary to raise output into balance with demand and attract workers. Firms would have been willing to produce more at existing prices, and workers would have been willing to supply their labor at existing wages, if they could not raise them. But both groups preferred

*Revision of seasonal factors since the above was written has slightly altered the wholesale industrial price pattern so that it is now consistent with the other indexes.

raising wages and prices, because others had been doing so and because, with expansion underway, they anticipated that their production costs or living costs would be rising and that the market would absorb their products or labor at higher prices or wages. How probable this more pessimistic scenario was could not be known, but it was not a negligible possibility.

Moreover, even if the more pessimistic outcome was actually unlikely, there was widespread fear of it, and this fact was itself important. Anxiety about inflation among consumers was believed to be holding back a revival of consumer spending. Long-term interest rates had been rising in the spring and summer of 1971; this may have been a sign of renewed inflationary expectations. An opinion common in the financial community was that stimulative actions by the Government would intensify the fear of inflation, cause a more rapid increase of interest rates, and finally hurt rather than help the economic expansion. Also, the idea that the American inflation was endless and uncontrollable was undermining confidence in the U.S. dollar and aggravating the balance-of-payments problem. These fears inhibited the Government from taking steps to expand the economy.

In this situation then, the purposes of the controls were threefold:

1. To reduce the risk that the rate of inflation would rise again and to increase the probability of further decline;

2. To reduce the fear that the rate of inflation would rise or not decline further; and thus,

3. To strengthen forces for expansion in the private economy and free the Government to follow a more expansive policy.

The controls were to be used to help achieve these goals subject to the conditions that they:

1. Should not interfere with the expansion of the economy. For example, they should not discourage private investment.

2. Should not impair the rise of productivity by reducing incentives to hold down costs or by precipitating strikes.

3. Should be fair in the sense that they should not adversely affect some groups or individuals and favor others.

4. Should not impose heavy administrative costs either on the Government or on private citizens.

5. Should not create or perpetuate a situation in which termination of the controls would be highly disruptive.

The controls were part of a larger program, which had the twin objectives of economic expansion and inflation reduction. The broader program included a fiscal and monetary policy which would initially be strongly expansive but would become less so as the economy reached higher levels and as the danger of excess demand became greater. One of the major concerns of the Administration when it instituted controls was that the country would come to rely on the controls and feel relieved of the necessity to exercise restraint in Federal spending when restraint became appropriate. This concern was related to the belief that controls would not in fact be able to hold down prices and wages when there was a strong excess of demand, and that the effort to do so would result in shortages and distortion of production.

Another program element, which became more significant as the year progressed, was the attempt to use the policies of Government to hold prices down in situations of shortage by promoting expansion of supply. The food sector provided the leading instance of this approach.

The controls program was intended to be temporary. This was true not only of the freeze, but also of Phase II and its modifications as they developed during 1972. Some believe that the United States faces a permanent problem of serious inflation beyond the capacity of prudent fiscal and monetary policy to control. In contrast, the Administration expected that if the total package of policies were well managed it would be possible to enter a period of reasonable price stability without controls. In any case the control system of 1972 was not designed to last forever. If a means of dealing with a more prolonged problem were needed, it would have to be created especially for that purpose.

In the following pages of this chapter, after a very brief description of the program, we review how far its objectives were achieved by the end of 1972 and, what is much more difficult, to what extent they were in fact achieved by the program itself.

THE NATURE OF THE PROGRAM

The supplement to this chapter, included in Appendix A, contains a description of the controls program. Further details may be found in the *Quarterly Reports* of the Cost of Living Council and in the regulations issued by the Council, the Pay Board, and the Price Commission. Here we summarize only the most salient points.

1. *Goals.* The goal of policy was to get the rate of inflation, as measured by the consumer price index (CPI), down to 2–3 percent by the end of 1972. The upper end of the range was considered to be not far below what might have been optimistically expected without controls; but at the same time it would represent significant progress from the earlier rate of inflation. The goal was set in the expectation that food prices would not rise significantly more than other prices.

2. *Pay standard.* To achieve this goal the Pay Board (initially consisting of five members each from labor, management, and the general public) set a basic standard of 5½ percent for permissible pay increases. This figure was related to the inflation goal through a "normal" or trend productivity increase of 3 percent, which would yield a 2½-percent increase in unit labor costs. A number of exceptions, some formulated by the Board and some imposed by Congress in the Economic Stabilization Act Amendments of 1971, permitted increases beyond 5½ percent. But the standards only set maximum limits; they did not set a floor.

3. *Price standard.* The Price Commission specified that prices could increase above their August 1971 level no more than would be proportional to the increase of costs over the same period, subject to the further proviso that, if prices were raised, a firm's profit margin in relation to sales could not exceed the average rate of the best 2 of the 3 fiscal years preceding August 1971. Again a number of exceptions were made, generally further limiting permissible price increases.

4. *Term limit pricing (TLP).* Agreements were worked out individually by the Price Commission with many of the largest companies, specifying the maximum amount by which they could raise their average prices during the coming year. Thus the companies were relieved of the necessity to obtain advance approval for individual price increases and the Price Commission was relieved of a considerable administrative burden. The agreement usually specified a maximum amount by which any individual price could be raised. For example, the agreement might provide that a company's average price could not rise more than 1.8 percent and that no single price could rise more than 8 percent. The TLP did not relax the profit-margin limit for the firm.

5. *Firm-by-firm control.* Price and wage control was exercised on a firm-by-firm basis, and on the basis of collective bargaining units. The control agency did not set ceiling prices at which specified commodities could be sold by any seller. It did not set ceiling wage rates for particular individuals or occupations. Instead it laid down rules by which the individual company could determine its ceiling prices, and these might differ from the ceiling price at which a different company sold the same commodities. Similarly the rules limited the average wage increase for the workers covered by a single company or bargaining unit, and these increases might permit different pay for the same occupation in different firms. Such a system kept the administrative burden on the Government small and was probably the only feasible way to make a rapid transition from the freeze to the more flexible controls of Phase II. On the other hand, the firm-by-firm approach may have raised the costs of compliance for the private sector. The variations that the system allowed in different firms' prices for the same product might have been a source of inefficiency and inequity in a situation of excess demand, but, under the conditions prevailing in most industries during 1972, competition tended to bring about uniform prices despite differences in ceilings.

6. *Exemptions.* The most important exemption from the controls system applied to farm products, defined to include timber and unprocessed fishery products also. The reason for the exemption was that pricing of these products took place in extremely competitive markets and adjusted quickly to changing market conditions; repressing price increases by controls would therefore cause shortages and require rationing. Interest rates were not subject to mandatory controls for the same reason, although voluntary restraint was sought in raising administered interest rates (mortgage rates, con-

sumers' credit rates, and the banks' prime lending rate). Imports and exports were also exempt. The Economic Stabilization Act exempted wages of low-income workers from control, and the subsequent definition of this class excluded about 40 percent of all private nonfarm workers. After the Phase II system had been in operation for some months, firms, collective bargaining units, and landlords, below certain size limits, were exempted from control. This removed from control the largest proportion of all economic units in the country, permitting administrative resources to be concentrated on the remaining units, which still accounted for most of the economic activity and which, by their competition, restrained price increases in the uncontrolled sector.

7. *Administration and reporting.* For checking compliance with the price standards, firms were divided by size into three tiers. The largest, Tier I firms, were required to notify the Price Commission and obtain approval in advance of price increases, unless they had a prior term limit pricing agreement. Tier II firms submitted quarterly reports, as did the Tier I firms; but the Tier II firms were not required to submit advance notification of increases. Tier III firms were not required to submit reports but were expected to maintain records which would permit auditing of compliance. Somewhat comparable procedures were established for monitoring pay increases.

PRICES AND WAGES DURING THE CONTROLS PERIOD

According to the indexes which provide comprehensive measures of the movement of prices in the United States, the rate of inflation has declined significantly during the controls period (Table 15 and Chart 7). Price behavior has been dominated by two facts: The rate of increase of prices other than farm prices declined markedly compared with the precontrol period; and the rate of increase of farm prices increased markedly compared with the precontrol period. The decline in the rate of inflation obviously is therefore smaller in indexes which accord a heavy weight to farm and food prices than it is in more comprehensive indexes like the consumer price index, the gross national product (GNP) deflator, the private output deflator, and the personal consumption expenditure deflator. Only the wholesale price index (WPI) fails to show this slowdown in the rate of inflation. However, the WPI reflects the prices of only about half the output produced or purchased in the United States, and it gives considerably more weight to farm products than is present in family budgets or in the national economy.

The broad price indexes clearly show the sharp decline of the inflation rate during the freeze, the rise during the bulge after the freeze, and a decline thereafter to a rate below that of early 1971. The sole exception is farm products.

TABLE 15.—*Changes in price measures, 1968 to 1972*

[Percent; seasonally adjusted annual rates]

Price measure	Pre-freeze			Freeze	Bulge	Post-bulge
	Dec. 1968 to Dec. 1969	Dec. 1969 to Dec. 1970	Dec. 1970 to Aug. 1971	Aug. 1971 to Nov. 1971	Nov. 1971 to Feb. 1972	Feb. 1972 to Dec. 1972
Consumer price index:						
All items	6.1	5.5	3.8	1.9	4.8	3.0
Food	7.2	2.2	5.0	1.7	9.7	3.6
All items less food	5.7	6.5	3.4	2.3	2.9	3.0
Commodities less food	4.5	4.8	2.9	.0	2.4	2.5
Services [1]	7.4	8.2	4.5	3.1	4.7	3.3
Wholesale price index:						
All commodities	4.8	2.2	5.2	−.2	6.9	6.5
Farm products and processed foods and feeds	7.5	−1.4	6.5	1.1	14.7	14.7
Industrial commodities	3.9	3.6	4.7	−.5	4.0	3.4
	1968 IV to 1969 IV	1969 IV to 1970 IV	1970 IV to 1971 II	1971 II to 1971 IV	1971 IV to 1972 I	1972 I to 1972 IV [2]
Fixed weight GNP price deflators:						
Total GNP	5.4	5.1	5.9	3.0	6.1	3.2
Gross private product	5.1	4.5	5.0	2.6	4.5	2.9
Personal consumption expenditures	5.0	4.3	4.5	2.4	3.6	2.8
Implicit GNP price deflators:						
Total GNP	5.3	5.3	5.1	2.2	[3] 5.1	2.3
Total U.S. purchases [4]	5.3	5.5	5.0	2.3	[3] 5.3	2.6
Private business GNP:						
Nonfarm	4.7	5.1	4.3	1.2	3.6	1.5
Farm	10.4	−7.3	12.1	16.3	20.1	21.5

[1] Based on unadjusted indexes as these prices have little seasonal movement.
[2] Preliminary.
[3] Increase in pay of Federal Government employees accounted for about 1¼ percentage points of the total increase.
[4] Total GNP less net exports of goods and services.

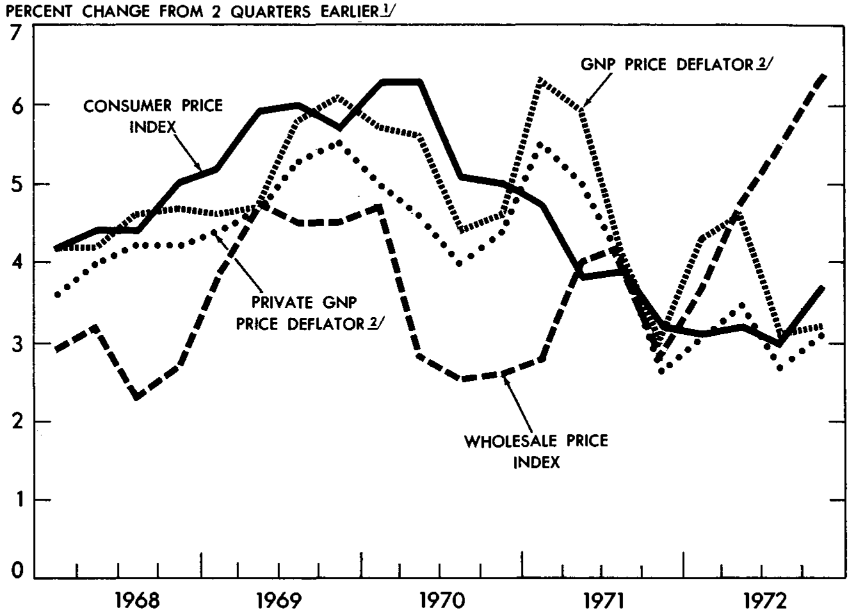
Sources: Department of Commerce, Bureau of Economic Analysis, and Department of Labor, Bureau of Labor Statistics.

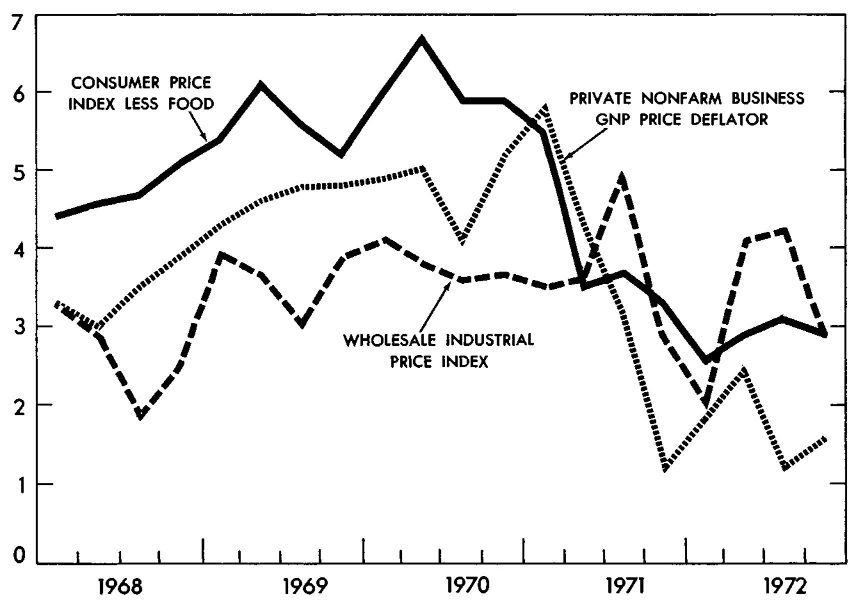
Since most nonfarm prices were subject to controls and farm prices were not, it is theoretically possible that the controls generated pressures which increased farm prices. This possibility is significant because food prices are an important part of consumer budgets. However, there is no evidence to indicate that the increase of farm prices was stimulated by the control of prices in other sectors.

There is, on the contrary, considerable evidence which points to domestic supply conditions and an increase in foreign demand as the main contributors to the rise in farm prices, and these two factors would have had much the same effect even in the absence of a controls system. The supply of food for domestic consumption not only failed to rise but actually declined on a per capita basis, for two reasons. First, domestic food production declined because of unfavorable natural conditions, including the earlier corn blight and bad weather in 1972; hence, despite a rise in imports and a reduction in carryover stocks, the supply available for domestic use and exports fell. Second, food exports increased significantly because of bad growing weather

Chart 7

Changes in Prices





1/ SEASONALLY ADJUSTED ANNUAL RATES.

2/ CHANGES BASED ON FIXED WEIGHT INDEXES.

SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR.

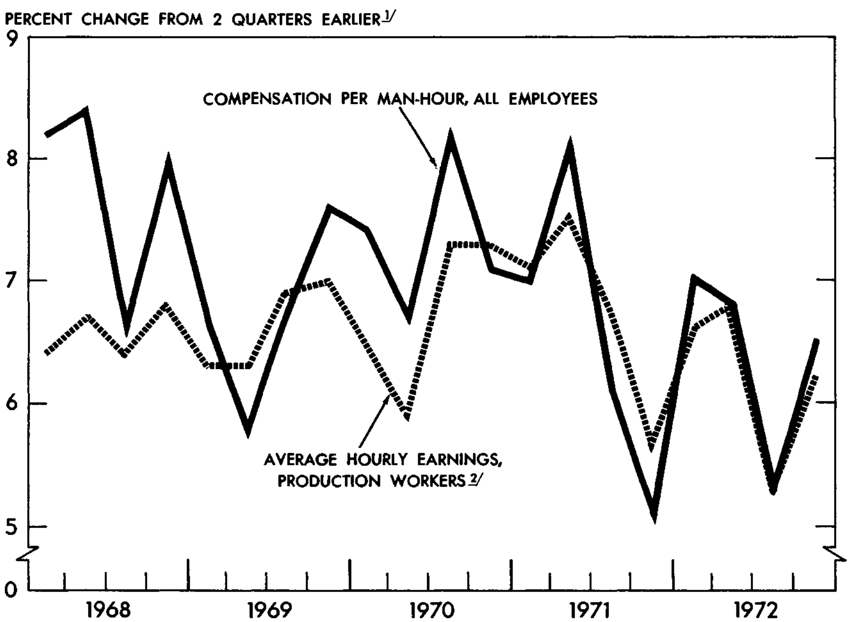
abroad. These exports were facilitated by U.S. arrangements to permit the financing of grain exports to the U.S.S.R.

An additional factor which retarded the decline of some of the indexes was the behavior of import prices. Because of the devaluation of the U.S. dollar and rapid inflation abroad, the dollar prices of imports rose more rapidly than U.S. prices. As a result, indexes which reflect prices of U.S. purchases, such as the CPI and the personal consumption expenditure deflator, rose more rapidly than indexes which reflect the prices of U.S. output, such as the GNP deflator and the private output deflator. This difference in behavior is reflected in the comparison, near the bottom of Table 15, of the price deflator for GNP and the price deflator for total U.S. purchases (GNP plus imports minus exports).

Statistics on wage increases also showed a marked deceleration during the controls period. Here too there is an initial sharp decline associated with the freeze, followed by a brief upsurge in the months after the freeze, and then a settling back to a rate below the level prior to the freeze. Several measures of wage change are shown in Table 16 and Chart 8.

Chart 8

Changes in Compensation in the Private Nonfarm Economy



1/ SEASONALLY ADJUSTED ANNUAL RATES.
2/ ADJUSTED FOR OVERTIME (IN MANUFACTURING ONLY) AND FOR INTERINDUSTRY EMPLOYMENT SHIFTS.
SOURCE: DEPARTMENT OF LABOR.

TABLE 16.—*Changes in wage measures, 1969 to 1972*

[Percent; seasonally adjusted annual rates]

Wage measure	Pre-freeze		Freeze	Bulge	Post-bulge
	Aug. 1969 to Aug. 1970	Aug. 1970 to Aug. 1971	Aug. 1971 to Nov. 1971	Nov. 1971 to Feb. 1972	Feb. 1972 to Dec. 1972[1]
Average hourly earnings, private nonfarm economy[2]	6.9	6.9	3.1	9.5	5.6
	1969 II to 1970 II	1970 II to 1971 II	1971 II to 1971 IV	1971 IV to 1972 I	1972 I to 1972 IV[1]
Average hourly compensation, all employees:					
Total private economy	7.2	7.6	5.2	8.9	5.7
Nonfarm	7.1	7.6	5.1	8.9	5.9
Average hourly earnings, private nonfarm economy[2]	6.5	7.4	5.7	8.0	6.0

[1] Preliminary.
[2] Adjusted for overtime (in manufacturing only) and interindustry employment shifts.

Source: Department of Labor, Bureau of Labor Statistics.

Additional evidence of the decline of the inflation rate is provided by the substantial reduction in the size of negotiated increases in collective bargaining agreements covering 1,000 or more workers; the typical wage increase negotiated for the first year of a contract had been 11.8 percent for the first 9 months of 1971 and 11.9 percent during all of 1970. In contrast, this first-year increase declined to 7.6 percent for all of Phase II and to an even more moderate 6.6 percent during the last 3 quarters of 1972. For manufacturing alone, the first-year increase was 8.1 percent in 1970, 11 percent during the first 9 months of 1971, and 6.9 percent during Phase II. Construction first-year wage increases, which had averaged 18.1 percent in the 4 quarters prior to the establishment of the Construction Industry Stabilization Committee in early 1971, slowed to 12.5 percent during the first year of the CISC's operation and to 5.8 percent during the last 3 quarters of 1972.

Did Controls Reduce the Inflation Rate?

The fact that the rate of increase of both prices and wages declined during the controls period does not prove that the controls themselves reduced the rate of inflation. There are, naturally, two views on this subject: one is that they were effective and the other is that they were not.

Those who say the controls were not effective rely primarily on the observation that the rate of inflation was declining before the controls began and that no sharp discontinuity in the decline of the rate of inflation can be dated from the beginning of the controls. Although a sharp cut in the inflation rate accompanied the freeze, and a bulge followed the relaxation of the freeze, these can be regarded as only briefly displacing in time the trend of prices that would otherwise have occurred.

The difficulty with this argument lies in the absence of any assurance that the decline in the inflation rate which had occurred before the freeze would have continued without it. The controls were imposed largely because there was no such assurance. Some of the reasons for the fear that the inflation rate would not continue to decline have been given earlier in this chapter.

The facts are that some price and wage increases were below the permitted amounts and that there have been few if any cases of shortages at ceiling prices. But the first of these points is not inconsistent with the controls having held down the average rate of inflation by holding down a significant number of price and wage increases. And the second point is consistent with the underlying rationale of the controls, which is that the price and wage increases to be restrained were not increases necessary to avert shortages.

The case for the effectiveness of controls rests in part on econometric study of the relation between the rate of inflation and other variables, such as unemployment, prior inflation rates, and growth of demand. The relations derived from past experience are used to project what the inflation rate would have been in the absence of controls. Since, as has turned out in several studies, the projected inflation rate was larger than the rate actually experienced in 1972, the conclusion is that the controls reduced the inflation rate, and by the amount of the difference. Although these studies ask the right question—What would the inflation rate have been without the controls?—the poor record of this technique in predicting the rate of inflation prior to controls does not inspire confidence in their answer, and evidence from this source must be regarded as inconclusive.

One interesting set of facts bearing on the effectiveness of the controls system is the distribution by size of wage adjustments in collective bargaining agreements. The data are shown in Table 17. The reduction from 1970 and 1971 to 1972 in the percentage of workers receiving increases of 10 percent or more is striking, and it may reflect the curtailment of big increases by the controls. In 1968, when there were no controls and the average increases were about the same as in 1972, the percentage of very large increases was also much less than in 1970 and 1971. Still, the 1972 distribution is more compressed than that of 1968, at least in manufacturing: the proportion of very large adjustments was below the 1968 level. The group of industries negotiating increases in 1972 was different from that in 1968, however, and this may help explain the difference in the distribution.

We believe it is probable that the controls did reduce the rate of inflation, but the magnitude of the reduction is uncertain. There are a number of individual cases in which the controls seem to have restrained price and wage increases, and it is hard to find cases in which the controls have stimulated increases. The slowdown of wage increases and of the private GNP deflator is more pronounced during the controls period than before it. But

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TABLE 17.—*First-year wage rate changes in collective bargaining agreements covering 1,000 workers or more, 1968 and 1970–72*

Type of wage-rate action [1]	Percent of workers affected							
	All industries				Manufacturing			
	1968	1970	1971	1972 [2]	1968	1970	1971	1972 [2]
All wage actions	100	100	100	100	100	100	100	100
No wage increase	(3)	(3)	1	2	(3)	(3)	1	1
Increase in wages	100	100	99	98	100	100	99	99
Under 1 percent	--------	--------	(3)	(3)	--------	--------	1	--------
1 and under 2 percent	(3)	--------	(3)	1	(3)	(3)	(3)	(3)
2 and under 3 percent	2	(3)	(3)	2	2	(3)	(3)	2
3 and under 4 percent	2	1	1	4	2	1	1	2
4 and under 5 percent	7	1	1	7	8	1	2	6
5 and under 6 percent	12	3	3	20	11	6	4	23
6 and under 7 percent	19	17	9	20	27	33	16	24
7 and under 8 percent	34	11	5	16	25	18	7	19
8 and under 9 percent	6	8	7	7	7	10	9	16
9 and under 10 percent	6	5	10	8	8	6	6	2
10 percent and over	12	54	61	12	9	24	53	4
Not specified	1	1	1	--------	1	(3)	(3)	--------
Number of workers (thousands)	4,589	4,675	3,978	2,092	2,277	2,184	1,913	792
Mean adjustment (percent)	7.4	11.9	11.6	7.0	7.0	8.1	10.9	6.6
Median adjustment (percent)	7.2	10.0	12.5	6.3	6.9	7.5	10.1	6.2

[1] Percent of estimated average hourly earnings excluding overtime.
[2] Preliminary.
[3] Less than 0.5 percent.

Note.—Detail may not add to totals because of rounding.

Source: Department of Labor, Bureau of Labor Statistics.

one cannot be sure that the controls had an effect on the rate of inflation. Still less can the size of the effect be gauged.

However, this uncertainty does not imply an equal uncertainty about the value of the controls. As we said at the outset, the controls were intended to deal with the *risk* that inflation would again accelerate. To reduce that risk substantially, as we believe the controls did, was a very significant contribution, but one that would not necessarily show up in a reduction of the inflation rate below what would most probably have occurred without the controls.

Reducing Inflationary Expectations

The goal of policy in 1971 and 1972, as we have pointed out, was not only to reduce the probable rate of inflation but also to reduce the general fear of continued or rising inflation and thus to increase confidence in the achievement of price stability. A change in the perception of the U.S. inflation problem has taken place. The controls have made a substantial contribution to this.

There are no completely satisfactory measurements of people's expectations and fears about inflation. But everyone who has examined his own thinking and the thinking of other people in 1970, 1971, and 1972 can see that a change has occurred since the controls were imposed, and these changes are reflected in available public attitude surveys. For example, the proportion of people surveyed in a poll who said they thought there was a current danger of inflation declined from about 85 percent just before the freeze to about 60 percent in December 1972. The proportion who said they feared inflation at that time more than a year earlier fell from 70 percent to about 35 percent. Any other outcome would be strange. For a great many people the idea that inflation could be reduced by fiscal and monetary restraint is unreal and abstract. Disbelief on this score was reinforced by the disappointing contrast between the many forecasts that inflation would decline markedly in 1970 and 1971 and the actuality. On the other hand, nothing seems more obvious than that the imposition of controls should curb inflation. Moreover, the controls had a symbolic value as evidence of the Government's determination to take whatever steps might be necessary to check inflation.

Concern about inflation did not, of course, disappear. From time to time in 1972 it was even fairly acute. Nevertheless, one has only to recall the tone in which the problem was usually discussed in the summer of 1971 to see how far we have come.

One of the most striking changes has been in the attitude of the international economic community toward the American inflation; before August 1971 it was the major concern of foreign observers and investors. By the end of 1972 the American anti-inflation policy had become the marvel of the rest of the world (Table 18). Largely because of this change the rest of the world is willing to hold increasing amounts of dollars.

TABLE 18.—*Changes in consumer prices in the United States and OECD countries, selected periods, 1958 to 1972*

[Seasonally adjusted annual rates]

Country	Percent change						
	1958–59 average to 1968–69 average	From previous year		From previous half-year			1972, second to third quarter
		1970	1971	1971 first half	1971 second half	1972 first half	
United States	2.1	5.9	4.3	4.2	3.5	3.1	3.6
Other OECD countries:							
Canada	2.3	3.3	2.9	2.5	4.9	4.3	7.4
Japan	5.1	7.8	6.1	6.6	5.9	3.0	6.1
France	3.9	5.5	5.6	5.1	6.4	4.9	9.0
Germany	2.4	3.8	5.2	5.4	6.1	4.7	8.7
Italy	3.5	5.0	4.9	4.8	4.9	4.9	8.7
United Kingdom	3.3	6.4	9.4	10.3	9.1	5.1	10.5
All other OECD countries [1]	3.8	5.3	7.4	7.2	8.8	6.6	8.2

[1] 1970 private consumption weights and exchange rates used. Includes Austria, Belgium, Denmark, Finland, Greece, Iceland, Ireland, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, Turkey, and Yugoslavia.

Sources: Department of Labor, Bureau of Labor Statistics, and Organization for Economic Cooperation and Development (OECD).

One objective indicator of inflationary expectations is the behavior of interest rates, particularly those on long-term obligations. When increased inflation is generally expected in the economy, lenders demand higher interest rates to compensate them for the depreciation of the real values of their loans. Borrowers are willing to pay higher rates because their resources are expected to appreciate in nominal terms. Interest rates, therefore, tend to rise and fall in direct relation to changes in inflationary expectations. The expected rate of inflation is, however, by no means the only factor determining the behavior of interest rates, nor is it easy to distinguish its effect from the effects of other factors operating at the same time.

The behavior of interest rates after August 15, 1971 strongly suggests that inflationary expectations receded abruptly as a result of the imposition of the Economic Stabilization Program. On August 16 the yield on seasoned 3–5 year Treasury securities fell 40 basis points from August 13 levels, and the Moody's Aaa long-term bond yield fell 20 basis points. By the end of August these yields had fallen 75 and 26 basis points, respectively, from the levels on August 13.

The declines in these yields were very sudden. Because they took place so quickly, they cannot be explained by any fundamental force except expectations. Hence a strong presumption exists that people believed the effects of the freeze would not be completely reversed and that they expected the inflation rate to follow a lower course after August 15 than before.

While long-term interest rates rose early in 1972, they generally followed a downward path after April, although scattered increases occurred, particularly in September. The declines took place in a period in which the economy was expanding rapidly, at a pace seldom equaled, and short-term rates were rising. Both of these forces are normally associated with increases in long-term rates as credit demands increase and expectations of future short-term rates are revised upward; only twice in the past 26 years had long-term rates declined over such a long period in such circumstances.

The fact that long-term interest rates declined on balance during 1972 even in the face of strong economic expansion suggests that long-term inflationary expectations which influence such rates were also revised. While short-term expectations appear to have been quickly revised in 1971 after the imposition of controls, investors in long-term securities took longer to become convinced that inflation would remain on a lower path for a considerable period to come.

The Fairness of Controls

In the development and management of the controls system, a great effort has been devoted to achieving fairness, both in justice to those directly affected and because belief that the system is fair is necessary to ensure the voluntary support without which the system could not function. According to the concept of fairness underlying the controls, the system itself should not substantially alter the distribution of income that would have occurred in an expanding, noninflationary economy without controls.

Fairness in the controls system can be understood in small or large terms: through the impact that controls exert on particular individuals and businesses or the effect on such large classes as wage earners and stockholders. In particular instances there was undoubtedly some arbitrariness. The regulations were inevitably broad and general; case-by-case handling of inequities was slow. As the year passed, feeling grew that individual treatment by the system had not always been equitable.

Public discussion and complaint about the fairness of the system have related chiefly to the larger aggregates, however, especially to the relation between wages and profits. In these terms it is hard to see that the controls system has changed the distribution of income. If there has been any change compared to what would have happened in a strong expansion without controls, it seems to have been favorable to wages. Employees' compensation rose from 75.1 percent of the national income in the second quarter of 1971 to 75.3 percent in the third quarter of 1972, despite the normal tendency of the labor share to decline when output expands rapidly. Related to gross national product, the employee compensation percentages are 61.3 and 61.0, respectively. As is shown in Table 12, Chapter 1, employees' share of the gross product of nonfinancial corporations declined insignificantly (from 66.4 percent to 66.1 percent) over the same period. Also shown in Chapter 1 (Table 11), the rise in profits relative to the rise in GNP has been much smaller in the current recovery than in earlier business recoveries; a related fact is the modest increase in corporate dividends, which have risen much less than employee compensation.

It seems quite clear that the share of labor in the national income has not suffered at the expense of profits during the controls period. Yet it is also true that real hourly labor compensation (compensation adjusted for the cost of living) in the private nonfarm sector has not risen as fast as output per hour in the private nonfarm sector. It is a well-known proposition of economics that if real compensation per hour does not rise as fast as productivity, labor's share declines. However, this proposition holds only if the prices used to deflate hourly money compensation and convert it into real compensation are the prices of the workers' products. In the present case, prices in the private nonfarm sector rose much less than the consumer price index because of the large influence of farm prices and import prices on the latter index. Therefore, real hourly compensation in terms of the things workers produced rose much more than real compensation in terms of the CPI market basket (and it is the former which is relevant for the proposition about shares). From the second quarter of 1971 to the fourth quarter of 1972 the purchasing power of the compensation for an hour of work in the private nonfarm sector rose at an annual rate of 2.8 percent in terms of the items included in the CPI, but at 4.2 percent in terms of the goods produced in the private nonfarm sector.

In a larger sense, workers gained much more from the controls program than can be shown by calculations of their proportionate share in the national income. The confidence engendered by the program was an important ingredient in the economic expansion which greatly increased employment, hours of work, and productivity, and thus the real incomes of workers. Real weekly earnings of private, nonfarm production workers (adjusted for the CPI) rose at an annual rate of 3.4 percent from August 1971 to December 1972 compared to 3.0 percent in 1971 prior to the freeze and to an average of 0.4 percent per year from 1965 to 1970. Total employment, including the Armed Forces (which declined), rose by 3.2 million from the second quarter of 1971 through the fourth quarter of 1972, and the total real compensation of employees rose at an annual rate of 5.7 percent.

THE COSTS OF CONTROLS

The actual or potential benefits of price and wage controls in reducing both the inflation rate and the fear of inflation must be balanced against their actual and potential costs. Several kinds of costs may be involved; almost all are difficult or impossible to measure. An impressionistic review suggests that these costs were probably not large in 1972, relative to the role that the system played in the national economy, but that they were growing as the year progressed.

1. *Administrative costs.* The controls program was designed to be carried out with a staff of less than 4,000 people. The annual rate of expenditure of the Cost of Living Council, the Pay Board, the Price Commission, and related agencies was about $80 million. The cost of administering the program, however, even within the Federal Government, amounted to more than this. The program was a demand on the time of the President and of the heads of many Government departments and agencies. This cost is to be measured in diversion from attention to other problems.

The administrative costs outside the Government were undoubtedly much larger than those borne by the Government. Many more man-hours were required to prepare applications and reports than to review them, and to maintain records than to check them. There is no calculation of what this cost amounted to in dollars, but it was probably substantial.

By the end of 1972 it appeared that the administrative costs would increase substantially if the program continued without modification. In a continuing program, companies and workers would insist on more equitable procedures that they did not demand when the system was considered to be short-lived, and they would have more recourse to the courts to get their full rights.

2. *Industrial disputes.* Previous experience, both in the United States and elsewhere, suggested the danger that wage and price controls might lead to exceptionally bitter industrial disputes and loss of time due to strikes. The disinflationary process would in any case require a slowdown in the rate of wage increases and thus carried with it the possibility of long strikes. This possibility might be aggravated if the Government entered the picture by setting standards for maximum pay increases. In such a situation, wage disputes could become tests of policy and power between Government and labor,

each party being unwilling to compromise and local cases threatening to explode into nationwide stoppages.

Despite the danger, 1972 turned out to be a year of unusual industrial peace. Time lost through strikes as a proportion of time worked was at its lowest level in nearly 10 years. This outcome was a consequence of the public's strong support for the program and the cooperative attitude among workers and the leaders of organized labor.

3. *Effects on productivity.* Price control systems tend in greater or less degree to be cost-plus systems which reduce the incentive to hold down costs and may even create an incentive in the other direction. The basic price standard in the 1971–72 controls program had this feature. Prices were generally permitted to be raised in proportion to costs, so that an increase of costs also permitted an increase of profits. This effect was at least limited by the requirement, adopted in May, that firms use an historical, industry-wide productivity factor in calculating costs, rather than their own actual or estimated productivity. However, firms would again be in the cost-plus situation if they reached their profit-margin limit, because an increase of costs would then permit an increase in profits.

Productivity rose sharply in 1972. The cyclical conditions for such a rise were highly favorable. Any adverse effect that the controls system may have had on productivity is not visible in the statistics, although this does not mean such effect was absent or negligible. Nevertheless, even anecdotal evidence of antiproductivity effects is rare. There were probably several reasons for this. Relatively few firms were up to their profit-margin standard in 1972. Even those which were at the profit-margin limit felt restraint on cost-raising tendencies because of competition from firms that were not. Moreover, the expected short life of the controls made businesses especially wary of falling into managerial practices that would be harmful when controls ended. All of these reasons suggested dangers as the controls continued, particularly in an economy operating closer to its potential.

4. *Effects on investment.* The price control system posed certain threats to the vigorous expansion of business investment. Profits were restrained by the cost pass-through rules as well as by the profit-margin standard. Furthermore, in the calculation of costs to justify price increases no allowance was made for the cost of nonborrowed capital. As a consequence, an increase in equity capital per unit of output would reduce the rate of return on equity, even though it permitted saving of other costs.

Despite these inhibiting factors, business investment rose substantially in 1972, and reports of business intentions suggest another substantial increase in 1973. Since investment is undertaken in expectation of a future stream of profits, the heavy investment of 1972–73 suggests that business viewed controls as likely to be of relatively brief duration. The restraint on dividend payments, which increased the internal funds of corporations, may also have helped to sustain investment growth.

5. *Distortions and interferences with production and distribution.* There are a number of classic ways in which long-maintained and rigid price controls in the face of excess demand distort the pattern of production and distribution. Low-margin goods disappear from the shelves, black markets and informal rationing appear, the quality of goods and services is degraded, and innovations are discouraged. Very little of this distorting effect showed up during 1972. There were stories, whose significance was difficult to measure, of a shift toward high-profit lines in the lumber industry, of favoritism in the allocation of lumber to dealers, and even of lumber production held back to await the end of controls. Relative prices under the controls induced production of more gasoline and less fuel oil than would have occurred in free markets. The ceilings on service fees charged by hospitals may have led to the provision of an unnecessarily large amount of services.

However, these cases were exceptional. They were kept from becoming more common by the flexibility of the controls system and by an even more important factor, the prevalence of unused production capacity during 1972.

WHERE WE STAND

By the end of 1972 the rate of inflation had been clearly reduced from its level when the freeze took effect. Moreover, what had happened was not merely a suppression of price increases that would burst out if controls were removed. Although some such increases might occur, a more durable change had taken place in the conditions underlying wage and price increases. Expectations of rapid inflation had diminished, and not only because of controls. Confidence in the Administration's determination to pursue a noninflationary fiscal and monetary policy had been strengthened.

An economic background for wage decisions had been established which was much more conducive to moderation than had prevailed earlier. Although workers had, on the average, been getting large wage increases in money terms in 1970 and 1971, they felt very little real improvement because of the rapid inflation. Consequently there was a strong push, recognized by employers as well as workers, for even larger wage increases. In contrast, at the end of 1972 workers had been receiving the same or smaller hourly wage increases, but the increase in their buying power during the year had been much larger. This contrast is shown in Table 19, which compares the conditions of 1972 with the conditions of 1969, that is, 1 year before many of the collective bargaining agreements to be negotiated in 1973 were last negotiated.

Developments during the controls period have thus improved the position of workers in the aggregate; they should also have particular relevance for employees in those sectors where bargaining activity in 1973 will be concentrated. In recent years, before the introduction of controls, wages in the major industries affected by collective bargaining agreements showed a persistent tendency to fall behind the rest of the economy during the term

TABLE 19.—*The economic preludes to two major collective bargaining rounds, 1970 and 1973*

[Percent change; seasonally adjusted annual rates]

Series	Backdrop to the 1970 negotiations: 1969 [1]	Backdrop to the 1973 negotiations: 1972 [2]
Consumer price index	6.1	3.2
Earnings in current dollars: [3]		
Hourly [4]	6.5	6.3
Gross weekly	6.2	6.7
Spendable weekly [5]	4.9	7.3
Earnings in constant dollars: [3]		
Hourly [4]	.4	3.1
Gross weekly	.1	3.4
Spendable weekly [5]	−1.1	4.1

[1] December 1968 to December 1969.
[2] August 1971 to December 1972.
[3] For production or nonsupervisory workers on private nonfarm payrolls.
[4] Adjusted for overtime (in manufacturing only) and interindustry employment shifts.
[5] Gross weekly earnings, after taxes, for a worker with three dependents. In annualizing the rates of change, the effect of the change in tax rates at the beginning of 1972 is taken into account separately.

Source: Department of Labor, Bureau of Labor Statistics.

of a multiyear agreement and then to catch up through larger increases when new agreements were negotiated. As the accelerating and high inflation rate has receded, however, a fundamental change has occurred in the manner in which inflation and long-term contracts have affected the relative position of unionized workers in the wage structure. Workers covered by many important contracts expiring in the near future appear either to have maintained or to have improved their relative position in the wage structure.

Thus the economic performance of 1971 and 1972 gave rise to several factors favorable to price stability in 1973. At the same time, this performance did not achieve a final liquidation of the extraordinary inflation problem left behind by the 1965–68 demand surge. The rise of prices, as measured by the consumer price index, was above the interim target rate set by the Administration and above the rate that would be considered permanently satisfactory. Apprehension about the future inflation rate, although much diminished, remained. Sensitivity to the vestiges of recent inflationary experience was heightened by the prospect and need for continued expansion and by the large number of workers who would be involved in new wage settlements in 1973.

A case could therefore be made for continuing the anti-inflationary influence of controls in 1973. But the experience of 1972 also suggested a number of dangers to be avoided. Although the costs of controls in retarding and distorting economic activity had apparently thus far not been great, these costs seemed to be rising. They could be much more significant in 1973 as the program aged and as the economy came closer to its potential. The number of instances of excess demand would multiply, and the relative price ceilings established by the system would become more potent sources of distortions. More and more companies would hit their profit-margin ceilings, with adverse consequences for cost control and for investment incentives. More insistence on formal and equitable procedures would arise, litigation would multiply, and administrative costs, public and private, would increase greatly. Less tolerance of the inevitable delays and red tape of the system would be forthcoming.

These dangers and difficulties did not mean that continuation of controls was impossible or undesirable. They did mean that even temporary continuation would require modification of the program. They reinforced the idea that controls should not be a permanent part of the American economic system. And they emphasized the need for maintaining general noninflationary economic conditions which would permit the controls to continue for a while and then to disappear. These considerations were all prominent in the development of the policy for 1973 which is discussed in Chapter 3.

CHAPTER 3

Outlook and Policy

THE PRINCIPAL QUESTION on the economic outlook for 1973 is not whether, but how fast, output and employment will expand. For policy, there are two issues. The first is to find and implement the set of policy actions which will maximize the likelihood that the economy will move to its full potential level of output and employment. The second is to do so in ways that will serve both to eliminate the vestiges of the post-1965 inflation and to place the economy squarely on a sustainable path of subsequent noninflationary growth.

This is an ambitious set of policy goals, but there is a good prospect of achieving them, or at least approaching them closely. The year ahead is the first in a long time in which there is reasonable hope of closing in on full prosperity without serious inflation and without war.

For this to become a reality rather than just a hope will require full cooperation from business and labor. It will also require coordinated policy actions by the Administration, the Congress, and the Federal Reserve System. The economy will be approaching the zone of its potential by the end of the year. Such an economy requires a disciplined balancing of conflicting short-run interests in order to ensure that the common prosperity, which benefits all interests, can be sustained without interruption.

The central need is to balance the speed of expansion against its durability, but in the context of 1973 this problem has many other dimensions: The allocation of output between uses dictated by the Government and those dictated by the private sector; the balancing of the need for allowing free operation of market mechanisms for determining individual prices and wages against the continuing need for restraint on the average level of prices; the division of emphasis between minimizing unemployment in the short run and minimizing it more permanently.

GUIDES TO OVERALL ECONOMIC POLICY

The basic mandate for policy set forth in the Employment Act is to achieve "maximum employment, production, and purchasing power." The question of the precise meaning of those goals was left unresolved when the Act was passed in 1946 and has remained open ever since.

In the early 1960's a judgment was put forward that maximum employment for that time would be achieved when 96 percent of the labor force was employed, which meant 4 percent unemployed. Paralleling this estimate was a calculation of "maximum output," usually called potential GNP, which was conceptually the output that would be realized if the economy were operating at full employment. Estimates of potential GNP, at constant prices, were actually derived by assuming that the potential level of output was equal to the level of actual output in mid-1955, and that it would increase at a trend rate based on underlying changes in population, the proportion of the population that would be in the labor force, hours of work, and productivity. The trend rate was adjusted from time to time to reflect changes in the underlying variables. The benchmark period, mid-1955, was selected because it appeared to reflect most of the characteristics associated with noninflationary full employment, including an unemployment rate close to 4 percent (the actual rate of unemployment for the second and third quarters of 1955 was 4¼ percent).

These estimates of maximum employment and potential output were not considered to be either immediate or permanent guides to policy. In fact, policy in the early 1960's recognized that too fast a push to maximum employment or potential output could be dangerous. At the same time the 96 percent employment rate, or 4 percent unemployment rate, was considered to be an "interim" goal, which might be changed later as a result of improvements in labor markets or other developments.

These judgments applied to conditions expected in the early 1960's. In retrospect, the standard they suggested seems to have been in the correct zone: Steady noninflationary expansion did raise the rate of employment to 95½ percent and the ratio of actual to potential output to 99 percent by mid-1965, and both rates might have risen somewhat further or could have at least been sustained without generating inflation, had the normal course of events not been disrupted by the subsequent rapid rise in defense spending and the associated budget deficits.

The standards are a less reliable guide to policy for the 1970's than they were for the 1960's. Large and unpredicted changes have taken place in the nature, composition and behavior of the labor force, employment and unemployment, as well as in the length of the workweek. Also the economy itself has been through the worst and most prolonged period of price and wage inflation since World War II. These changes have important implications for the guidance of policy.

Given that our knowledge of the interrelation between the levels of output, employment, and prices at "maximum employment" is incomplete, it would be preferable to think of each objective, not in terms of a single value but as a range of values. Furthermore, the behavior of the economy in the near future will be determined not only by whether it is operating below or above some numerical potential output or below or above some target rate of employment, but also by the speed and manner with which it approaches the range of its potential levels. Against the background of recent inflationary history it is necessary to give the economy reasonable assurance that policy will not repeat the fiscal errors which ignited the inflation in the first place. Too fast a dash for a numerical target of potential would rekindle inflationary expectations and behavior that might make the potential itself unattainable, and would make it unsustainable if attained, whereas a more gradual approach which allows for the sensitivity of wages and prices to expectations would make the potential not only attainable but sustainable.

The Government can neither precisely predict what maximum employment or maximum production will be nor can it precisely control the level of actual employment or production. What the outcomes should be and will be depends upon private behavior—upon the amount of work and production that people want to do on realistically achievable terms—as well as upon public policy. The contribution of public policy is to create conditions in which people can reach their desired employment and production goals through feasible behavior in the market. One aspect of this contribution is that the total demand for output in money terms should be sufficient so that people who want to work can find work without an unrealistically large departure from accustomed and expected patterns of wage behavior.

Specifically, in the current situation we believe these guides mean that the money value of output should rise at a rate which, with reasonably expectable price and wage behavior, would reduce the rate of unemployment to the neighborhood of 4½ percent by the end of 1973. The rise of money gross national product (GNP) would be about 9 percent from the end of 1972 to the end of 1973. This does not imply that in present circumstances 4½ percent is necessarily the floor to the unemployment rate. It does imply a belief that a more rapid expansion of the economy within 1973 would endanger the further reduction of the inflation rate that is desirable, and would do so despite the continuing price and wage controls program. However, if, as a result of cooperation with the controls system or for other reasons, prices and wages rise less rapidly than is assumed here, the increase in money GNP suggested for the year would permit output and employment to rise more and unemployment to fall further.

Policy beyond 1973 will have to be adaptable to developments during the year. However, in the absence of evidence to the contrary, a sustained period of uninterrupted expansion would provide the optimal background for maximizing both employment and price stability. To this end, the appropriate policy goal in the ensuing period would seem to be a steady increase of money demand (money GNP) at a rate consonant with the potential growth rate of the economy and reasonable price stability. Again, this would not imply that the unemployment rate of 4½ percent assumed to have been reached by the end of 1973 will not decline further. If, with 4½ percent unemployment, there is the pressure of an excess supply of labor the average rate of wage and price increase would be lower and the rise in employment relative to the labor force would be higher, leading to a further reduction of the unemployment rate.

A further reduction of the unemployment rate in 1974 and beyond to even lower levels would be assisted by labor market policies, including manpower programs, which effectively reduce the relatively high level of frictional and structural unemployment that has typically been experienced in the United States.

It is worth repeating that the policy goal is a condition in which persons who want work and seek it realistically on reasonable terms can find employment. The Government must make two kinds of contribution to the achievement of this goal. First, it must maintain reasonable stability in the overall rate of economic growth so that the efforts of individuals to find work are not frustrated by erratic changes in the conditions on which work is available. Second, it must seek to eliminate obstacles that prevent willing workers and willing employers from getting together, insofar as these obstacles can be overcome without excessive cost. When the condition that persons who want work can find it through serious search is met, the rate of unemployment as we measure it will not be zero. What it would be we do not know. Undoubtedly the number would change from time to time. But it is the condition which is important, not the statistic.

FISCAL AND MONETARY POLICY

The path of the economy suggested above calls for slowing down the rise of money GNP, which was about 11 percent during 1972, to about 9 percent during 1973 and to a steady rate less than that thereafter. This desired shift to a slower rate of increase of money GNP would be assisted by a shift of the budget—from a position in which the unified budget would be in deficit at full employment to a position in which it would be in balance at full employment. In fact, the strength of the private demand forces in the economy, described below, argues that this shift in the budget position is essential to avoid an inflationary pace of expansion. The desired subsequent steadiness of the rate of increase of money GNP would be assisted by keeping the budget in a position of balance at full employment, unless there later appears clear and strong evidence that developments in the private sector call for greater fiscal stimulus or restraint. Constancy in the relation between full-employment receipts and expenditures provides approximate constancy in the Federal contribution to economic expansion. The constancy of the contribution is only approximate because the impact of the budget on the economy depends on its composition and total size as well as on the size of the deficit or surplus. However, constancy of the balance at full employment is the best single guide to a budget policy that neither pushes the economy above its desired growth rate nor holds the economy below it. In any case, the rule that expenditures should not exceed the revenues that would be collected at full employment is essential to bring home the requirement that Government should not spend money for things it is unwilling to ask citizens to pay for. The circumstances of 1973 are appropriate for getting on to that track.

A gradual slowing down of the expansion of money GNP to a steady rate consistent with the long-run potential growth rate of the economy and reasonable price stability is also an appropriate goal for monetary policy. This is likely to require a slower increase of the supply of money and credit than was proper when the main objective was to encourage a quickened economic expansion in an environment of substantial unused resources.

There is, as far as we are aware, little explicit disagreement with the proposition that the budget should be brought into a position of full-employment balance for fiscal year 1974. The threat to the achievement of full-employment balance is not that the country or the Congress will decide against it but that congressional procedures will be incapable of carrying out a policy to do it. Congress, under present practice, makes hundreds of separate decisions affecting expenditures but does not decide at any point in the process what total expenditures should be. Lacking the discipline that would be imposed by recognition of a limit to total spending, Congress tends regularly to authorize and appropriate too much money, constantly straining the ability of the Executive to keep spending under control.

If the budget is not to be a perpetual menace to economic stability, better congressional procedures will have to be created for making a deliberate decision about total spending. That is why the President has urged the Congress to establish a rigid ceiling on fiscal year 1974 expenditures before it passes any other spending legislation this year. The President has also urged the Congress to act on its own initiative to reform its expenditure-deciding process. In fact the problem is now more recognized in Congress than it has been for many years and there have been encouraging moves there to deal with it.

We also need to consider whether the future conduct of fiscal policy could be improved if Congress were to develop expeditious procedures for temporary, limited changes in the level of particular taxes. Such changes could take the form of a temporary, 1-year, positive or negative surcharge rate on personal and corporate income taxes, or additionally a temporary, 1-year shift in the rate of the investment tax credit. Both suggestions have been advanced with some regularity over the past two decades, and while they raise many difficult questions it is also generally agreed that we cannot be complacent about our existing instruments for the conduct of fiscal policy.

Basic changes in the structure and level of tax rates do and should require extended discussion. At the same time, experience has shown that the proper conduct of macroeconomic policy may sometimes call for a prompt and effective shift in the overall balance between the flow of Federal receipts and expenditures. Temporary and prompt changes in tax rates, which do not alter the basic structure of taxes, may provide an efficient way of accomplishing such required shifts.

Government Expenditures

The shift to full-employment budget balance by 1974 can be accomplished either by raising tax rates or by restraining the rate at which expenditures rise. The Administration has a clear preference for the latter.

The conceptual basis for arriving at public expenditure decisions is fairly straightforward. In general, public expenditure is justified when both of two conditions are met: If a desired result can be achieved at less cost by public rather than private spending *and if* the expenditure yields benefits which (adjusted for their timing) are greater than their costs, measured by the value and timing of the alternatives that have to be foregone in order to finance the outlays required.

In practice, there are formidable difficulties in arriving at sound public spending decisions. For many expenditures, reliable estimates of benefits and costs are not available. Many decisions have spending consequences that stretch years beyond the point at which the decision itself is made; over this period, circumstances, priorities, costs, and benefits may and do change. The proper management of public spending therefore requires the continuous reevaluation of prior decisions from which current spending flows as well as the careful evaluation of new decisions. Furthermore it is instructive to gain perspective by referring to a rough guide such as the fraction of total output which flows through the government sector.

The United States has now been through a period of substantial growth of government expenditures, both absolutely and relative to the size of the economy. In making a comparison with the size of the economy it is useful to abstract from fluctuations in the level of actual output around its path of potential growth. To this end, the data shown in Table 20 relate the level of government spending and its major components to the level of potential GNP. Separate figures are shown for the Federal Government (including grants to the State and local level), the State and local sector (excluding Federal grants) and for all levels of government combined.

Excluding defense spending, the ratio of government expenditures—Federal and State and local—to potential GNP rose from 14 percent in 1955 to 23 percent in 1971. Defense spending fluctuated relative to GNP but was much lower at the end than at the beginning of the period. During these years, potential GNP, measured in nominal dollars, nearly tripled.

The share of the Federal portion in total government civilian spending also rose rapidly between 1955 and 1971. In 1955 Federal civilian spending was 6.6 percent of potential GNP compared to 7.4 percent for State and local spending. Over the 16-year period the Federal share rose twice as fast as the State and local share. By 1971 Federal civilian spending was 12.4 percent of potential GNP as against 10.5 percent for the State and local sector.

TABLE 20.—*Government expenditures as a percent of full-employment GNP, selected calendar years, 1955–71*

[Percent]

Type of expenditure	1955	1960	1965	1968	1971
Total government					
Total	24.5	25.3	27.1	31.6	30.2
Defense related [1]	10.4	9.0	8.7	10.3	7.3
Civilian	14.0	16.2	18.4	21.3	22.9
Education, health, and welfare [2]	8.5	10.1	11.7	14.1	15.9
Natural resources [3]	1.2	1.2	1.3	1.4	1.1
Commerce, transportation, and housing	1.8	2.1	2.3	2.5	2.4
General government and net interest	2.5	2.8	3.0	3.4	3.5
Federal Government [4]					
Total	17.1	17.3	17.9	21.2	19.7
Defense related	10.4	9.0	8.7	10.3	7.3
Civilian	6.6	8.2	9.2	10.9	12.4
Education, health, and welfare [2]	3.7	4.7	5.4	6.9	8.3
Old-age and disability	2.1	2.9	3.4	4.3	4.8
Other	1.6	1.8	1.9	2.6	3.5
Other civilian	2.9	3.5	3.8	4.0	4.1
State and local government [4]					
Total civilian [5]	7.4	8.0	9.2	10.4	10.5
Education, health, and welfare [2]	4.8	5.4	6.4	7.2	7.7
Other civilian	2.6	2.6	2.8	3.2	2.8

[1] Consists of national defense, space research and technology, and international affairs and finance. Negligible amounts of State and local expenditures for these functions are included in Federal expenditures.
[2] Consists of education, health, labor and welfare, and veterans benefits and services.
[3] Consists of agriculture and agricultural resources and natural resources.
[4] Federal expenditures include and State and local expenditures exclude Federal grants.
[5] See footnote 1.

Note.—Expenditures are on a national income accounts basis.
Detail may not add to totals because of rounding.

Source: Department of Commerce.

For all levels of government, the largest increases were recorded in spending for education, health, and welfare purposes. Total spending for such purposes rose from 8.5 percent of potential GNP to 15.9 percent, and Federal spending rose from 3.7 percent of potential GNP in 1955 (about $15 billion) to 8.3 percent in 1971 (about $93 billion). A large part of the rise was in spending connected with social security programs for the aged and disabled, although other forms of spending for education, health, and welfare functions also rose rapidly.

The rise in the share of Federal civilian spending in the United States has accelerated since the mid-1960's along with the large increase in the number and scope of social programs. Many of these were introduced without any firm estimate of how effective they would be in solving the problems to which they were addressed or how much they would cost in the long run. At the same time there has emerged the need for new social programs, especially in the field of pollution abatement.

The continued existence of large social problems alongside a greatly expanded volume of government expenditures designed to correct these problems is not a strong argument for devoting a still-larger share of the

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national output to similar government programs. On the contrary, it is an argument for close scrutiny of these programs to discover whether they can be justified by their results. Such a scrutiny, carried out by the Administration, has led to decisions to cut back many programs, even though total Federal spending, after the cuts, will still be rising by about $20 billion a year. Making these cutbacks in less effective programs will provide budget room for consideration of more effective programs later as the growth of the economy expands the Federal revenue.

PRICE AND WAGE RESTRAINTS IN PHASE III

The purpose of budget and monetary policy is to help the economy achieve sustainable expansion along the growth path of potential output. One necessary condition for achieving this objective is the avoidance of policy errors which risk the re-emergence of generalized demand-pull inflation. A second condition is that the risk of inflation related to cost-push and expectational factors should also be minimized. Inflationary expectations and behavior left over from the country's experience since 1966, even though reduced in 1972 from previous heights, have not been completely eliminated. The self-interest of both business and labor calls for restraint and hence can be expected to lead to an even more durable winding-down of inflationary patterns than the economy has already achieved. However, the reciprocal abatement of the rate of wage and price increases is a delicate and complex process that can be upset through unrestrained behavior by particular sectors of the price-wage spectrum. To avoid the risk of such disruption, it is necessary to maintain a system of direct wage and price restraints in 1973.

Although temporary continuation of controls in 1973 is necessary, the condition of the economy and of the controls system have pointed to the need for substantial changes in the program. Two things are critical. One is to restrain and, if possible, reverse the rapid rise of food prices. The second is to moderate the degree of detailed supervision and mandatory enforcement in the system in order to preserve the self-restraint which has been the essence of the progam.

In 1972 food prices rose much more rapidly than other prices. The reasons for this, and the steps taken to curb the food price increase, are described in Chapter 2 and its supplement. By the end of 1972 adverse weather conditions had further reduced the food supply in prospect for 1973. Moreover, it began to appear that these uncontrollable adversities were superimposed on an agricultural policy which, although less restrictive than it had been, still leaned too far in the direction of limiting output and stocks relative to the rising domestic and foreign demand. This was especially true for meat, where the programs adopted in the early 1960's had made a major change in the way farmers could use their cropland. Whereas previous programs had placed limits on actual acres of crops produced, and allowed other areas of land to be used for livestock grazing or production of minor crops, the new programs utilized a new concept. They restricted the production of major crops by paying farmers to idle a portion of the acres previously used in crop production. In return for the payment, the idle acres had to be planted to soil-conserving crops and could no longer be used for livestock grazing or other crop production during the most productive part of the year. This change had the effect of slowing the rate of growth of meat production after 1965. With strong growth in demand for meat in 1972, prices rose rapidly.

Arresting the rapid rise in food prices is a key element in the 1973 stabilization program, both because of the direct importance of food in family budgets and because of the possible link between food prices and moderation of wage increases. Accordingly, the revision of the Phase II program included major steps to restrain food price increases in addition to what had been done in 1972.

During January 1973 the Administration took a number of strong measures which will have an important impact on food supplies and food prices, although with some lag. These include:

1. Suspension for 1973 of mandatory acreage set-aside requirements under the wheat program.

2. Disposal of Government-owned stocks of grains, except for minimum reserves, to be completed promptly.

3. Termination of Government loans, effective May 31, 1973, on farmer-owned stocks of grains from crops of 1971 or earlier years.

4. Suspension of all remaining export subsidies for foods, applying to chickens, flour, and lard.

5. Permission for acreage diverted from crop production under Government programs to be used for grazing animals under arrangements to be agreed upon with the Department of Agriculture.

To help assure that the agricultural policies of Government are consistent with the anti-inflation objective, administrative actions of the Department of Agriculture affecting food supplies and prices will hereafter be subject to review by the Cost of Living Council (CLC). The CLC Committee on Food has been set up to discharge this function as well as to review or initiate other policies and proposals that may affect food prices. This can lead to a progressive reorientation of agricultural policy to the needs of the 1970's.

As in Phase II, mandatory controls will be continued on food processing and distribution. Large food processors will be required to comply with previous regulations, including prenotification and approval of cost-justified price increases. The limitations on retailers' margins established under the Phase II system will remain in force, except for minor administrative changes. Pay units in the food processing and retailing industries will remain under mandatory pay control.

Concern with the food price problem in 1972 led the Cost of Living Council to ask the National Commission on Productivity to undertake a study on ways to improve productivity and reduce costs in food production and distribution. The study, which has now been transmitted to the CLC for its consideration, contains numerous suggestions for both Government and private action. A Food Industry Advisory Committee, drawn from the private economy, has been established to advise the CLC on matters relating to food costs and prices. One of its main functions will be to assist in carrying out recommendations for raising productivity arising from the recently completed study.

Three other sectors of the economy, in addition to food, will receive special attention under Phase III.

(a) *Medical care.* Mandatory control of prices and wages remains in force in the health industry. The Cost of Living Council Committee on Health will review Government activities significantly influencing health-care expenses. A Health Industry Advisory Committee composed of private citizens will advise the CLC in this area.

(b) *Construction costs.* The Construction Industry Stabilization Committee will continue to operate as under Phase II to restrain wage increases in that industry. Construction prices are subject to reduction if scheduled wage increases are reduced.

(c) *Interest and dividends.* The Committee on Interest and Dividends will continue its efforts to obtain voluntary cooperation in holding down dividend payments and interest rates.

Outside of these particular areas, the main effort of Phase III is to bring about private action on wages and prices consistent with the goal of slowing down the inflation rate without imposing unnecessary burdens on the economy. These burdens, described in Chapter 2 as they related to Phase II, included administrative costs for the Government and the private sector, interferences with productivity and production, obstructions to the normal conduct of business and collective bargaining, weakening of incentives to investment, and a feeling of inequity on the part of some. Although surprisingly small during 1972, these burdens were becoming more serious and there was every reason to believe that they would become still more serious as the control system continued and as the economy moved closer to its potential.

These costs or burdens of the system were not essential for its basic objective. The objective was not to force prices and wages to conform in every particular case to precisely defined standards laid down by the Government, nor to obtain advance approval for every private action. The objective was a certain average degree of restraint. But prior to August 1971 private decisions had been made for a long time in a highly inflationary atmosphere. With that background, spontaneous wage and price decisions in 1972 could have come out a long way from the requirements of price stability, even given a general desire to cooperate in the fight against inflation. Thus the ability of the Government to monitor private behavior and enforce reasonable compliance with the requirement of price stability had to be developed and demonstrated. Therefore, the situation of Phase II required prenotification, precise standards, and omnipresent enforcement. The conditions at the opening of 1973 permitted and—if the system was to survive and succeed—required a relaxation of these forms of the system. This is the basic philosophy of Phase III.

The President has established a goal of getting the rate of inflation down to 2½ percent or less by the end of 1973. The Cost of Living Council has set forth standards of price and wage behavior which are consistent with the achievement of this goal. These standards are essentially the standards of Phase II, with some modifications on the price side which are noted below. The CLC has authority to change these standards. In considering modification of the pay standards the CLC will have the advice of a Labor-Management Advisory Committee composed of leading private citizens.

Compliance with these standards is expected to be initially and generally voluntary. The program will be self-administering, in the sense that private parties can calculate the application of the standards in their own cases. The experience under Phase II, and the regulations and definitions developed under it, were invaluable in making this possible. Businesses and collective bargaining units will not be required to notify the Government in advance of price or wage increases. The largest economic units will be required to submit quarterly reports to the Cost of Living Council, which will permit the CLC to assess their behavior relative to the requirements of the anti-inflation goal. Moderate-sized economic units will be required to maintain records for the same purpose. The parts of the economy not required to submit reports or maintain records will be surveyed from statistical and other information and are expected to follow the same standards.

When the Cost of Living Council believes that there have been, or are about to be, price or wage increases that are not reasonably consistent with the objectives of the program it can take action to stop them. Among other things, it can, if it considers it appropriate, issue an order under the authority of the Economic Stabilization Act setting a ceiling on specific prices or wages. This order might be temporary, pending a hearing. While the order is in effect, transgressing it will be a violation of the Act and subject to its penalties. In determining whether price or wage increases are not reasonably consistent with the objectives of the program the CLC will be guided by the standards it has issued.

The Price Commission and the Pay Board will no longer operate in Phase III, but many of their functions will be performed by Price and Pay Divisions of the Cost of Living Council. Rent control, which had already been cut down to cover about 30 percent of rental units, is terminated in Phase III, because it leads to costly evasions, enforcement is difficult, and housing market conditions have significantly improved. The total number of personnel assigned to the program will be reduced from about 4,000 to about 2,000. Relieved of the necessity to process a large flow of advance notifications, and to administer rent control, this staff will be adequate to maintain an effective option for the Government to intervene to assure achievement of the anti-inflation goal. The President has asked for a 1-year extension of the Economic Stabilization Act, which would otherwise expire on April 30, 1973.

One significant change has been made in the standard for prices. As in Phase II, prices may be increased only to reflect cost increases. These cost-based price increases are then subject to one of two further limits. First, the average increase in a firm's prices may not exceed 1.5 percent in a year; if this standard is observed the firm's profit margin will not be limited. Second, if a firm's average price increase exceeds 1.5 percent that firm may not exceed its base period profit margin. Thus, a firm is given the opportunity to exceed its base period profit margin if it does so by increasing productivity, without raising prices by more than 1.5 percent. The base period for calculation of the allowable profit margin is slightly altered by permitting the inclusion of fiscal years ending after August 15, 1971.

The essence of Phase III is that the Government retains the enforcement ability and authority necessary to the Nation's anti-inflation objective while leaving the private sector the maximum possible freedom to pursue productivity, efficiency, and collective bargaining.

THE OUTLOOK FOR 1973

The U.S. economy will expand substantially in 1973. All major components of demand will rise strongly except for residential construction and Federal purchases. Aggregate demand for goods and services will rise by about 10 percent, from an estimated 1972 level of $1,152 billion to about $1,267 billion in 1973.* The real increase is projected at 6¾ percent with an implied increase in the GNP price deflator of 3 percent. This projection of GNP prices is compatible with the objective that the rate of inflation, as measured by the consumer price index, be reduced to 2½ percent or less by the end of 1973. Civilian employment is expected to rise more rapidly than the civilian labor force, reducing the unemployment rate to the neighborhood of 4½ percent by the end of the year.

The course of the U.S. economy, at least through the first half of 1973, will be dominated by expansive forces already in place at yearend 1972. Business investment has developed a strong forward momentum, stimulated by both the fact and the expectation of expanding orders, sales, and profits. The ability and willingness of consumers to increase their purchases has been augmented by the large increase in social security benefits in the fourth

*Given the path of money GNP in 1972, an increase of 10 percent between the average level in 1972 and the average level in 1973 is consistent with an increase of 9 percent from the end of 1972 to the end of 1973.

quarter of 1972 and their incomes will be augmented again early in 1973 by Federal pay increases. The financial position of the State and local government sector, stronger than it has been in many years, will be strengthened further by both current revenue sharing payments and retroactive payments for 1972.

Given these expansive forces the probability is that the economy will maintain a very high rate of real growth over the first half of 1973. After midyear, the economy will be significantly closer to the zone of full potential output, and it is both probable and desirable that the rate of expansion will and should abate toward its sustainable long-run path.

The outlook for the major components of expenditure on GNP in 1973 is discussed in the following sections.

Business Fixed Investment

The Council expects the rise in business fixed investment to continue on its strong upward course and to increase by 14 percent from 1972 to 1973, about the same as the rise from 1971 to 1972. The last time two successive annual increases of this magnitude occurred was in the mid-1960's. A substantial part of the earlier increase took place before the rapid buildup of the war in Vietnam. The foundation for the large increase expected in 1973 has already been laid. The rapid expansion in 1972 has generated increased requirements for capacity expansion and has also provided business with a substantial part of the funds required for capital goods purchases: In addition to rising profits, the actual and potential availability of funds has been augmented by liberalized depreciation provisions, the investment tax credit, and the restraint on dividend increases, as well as by favorable financial conditions in the markets for debt and equity capital. This year's strong economy will sustain investment plans that have already been made and, indeed, will probably lead to their upward revision.

Several indications of forward investment commitments were noted in Chapter 1. Additional evidence can be found in the strong buildup in unfilled order backlogs held by producers of capital goods, which were 14 percent larger in November 1972 than a year earlier. Recent months have also seen a pronounced step-up in construction contract awards for factory building, which had been lagging for several years.

According to the most recent Commerce Department survey, taken in November and December and published in January, businessmen were projecting a rise of 13 percent in their plant and equipment expenditures from 1972 to 1973. The survey also projected a rise of 13½ percent for manufacturing companies. These results correspond fairly closely with a similar survey conducted by McGraw-Hill in late October. The manufacturing increases extended to almost all major industries and were especially large in the durable goods sector. Investment by nonmanufacturing business is expected to continue its steady upward trend for a projected rise of 12½ percent, with larger than average increases in spending by public utilities and mining.

The Council's forecast for an overall rise of 14 percent is basically consistent with the rise projected in the anticipations survey for 1973. One reason for a slightly higher forecast is that investment demand is expected to be strong in certain sectors not covered by the plant and equipment survey, notably investment in agriculture, and among professional businesses. A second reason is that over the postwar period anticipations have tended to underestimate actual results during periods of strong expansion.

It is interesting to note that experience in 1972 was an exception to the general rule: Business spent less on new plant and equipment in 1972 than was projected early in the year by both the Commerce and McGraw-Hill surveys. It is highly unlikely that the shortfall was due to disappointments in demand; indeed, capital appropriations, new orders, and contract awards all increased as 1972 progressed. A possible explanation for the shortfall which occurred is that construction and equipment costs did not rise as fast as originally expected, especially for older projects that had been planned several years previously and had been reactivated after postponement during the recession.

Inventory Investment

The change in business inventories is expected to total \$12½ billion in 1973, an increase of about \$7 billion over last year's level of inventory accumulation. Considering the strength of the rise in output and sales in 1972, inventory accumulation was relatively low. However, stocks relative to sales at the beginning of 1972 were still a little high by historical experience. In addition, most sectors experienced few problems with delivery delays, and under such conditions a major shift in inventory policy was not likely. The combination of last year's strong upsurge in sales and the moderate rise in stocks has reduced the ratio of stocks to sales for manufacturing and trade firms combined to its lowest level since 1966. One structural element that will help add to inventory investment this year is the increased demand—stemming from some of the capital-intensive manufacturing industries—for heavy equipment with long production lead times.

Residential Construction

Residential construction expenditures are expected to rise only slightly from 1972 to 1973 and to decline somewhat in real terms. Housing starts are expected to edge down gradually throughout 1973, averaging 2.2 million units as compared to 2.4 million in 1972. In general the decrease in new starts will reflect cutbacks in some areas where overbuilding has occurred, some reduction in the backlog of demand as this is satisfied by the very large volume of completions expected in 1973, and somewhat less favorable conditions in mortgage markets than prevailed last year. The number of new nonfarm housing units—public as well as private—to be started under HUDsubsidized programs is expected to exceed the 1972 level somewhat, even though new commitments under these programs are being discontinued.

The reduction in total starts is not expected to be severe because the underlying demand for housing—buttressed by strong formation of new households and replacement demand—continues to be very high. Furthermore, while some rise in interest rates may occur as a result of the strong upsurge in business activity, there is little possibility of the stringent financial conditions that led to shortages of mortgage funds in 1966 and 1969.

Government Purchases

Government purchases are expected to show mixed trends. State and local purchases are projected to rise by 12 percent, or by somewhat more than last year's 10 percent rise, due in part to the effects of revenue sharing. Many States and localities have indicated that spending increases related to revenue sharing receipts will take the form of capital projects, in which case the full impact of the new program on the economy will be deferred by the longer lags involved in planning and executing such expenditures. There will also be tax cuts from existing levels or the avoidance of tax increases that might otherwise have taken place in the absence of revenue sharing, and also some debt reduction. All of this may stimulate the economy but not in the form of higher government purchases.

Federal purchases of goods and services are scheduled to show little change from 1972 to 1973, which means a decrease in real terms. The year begins with a Federal pay raise for both military and civilian workers that is expected to add $2.2 billion a year to Federal payrolls, although part of this rise is expected to be offset by subsequent reductions in personnel.

Net Exports

Imports of goods and services are likely to exceed exports again in 1973 but the difference is expected to be narrower by about $2½ billion than was the case in 1972. The improving trend in the balance of trade that began in mid-1972 should continue through the coming year. Because the growth of U.S. output from yearend 1972 to yearend 1973 will be slower than it was in the preceding 4-quarter period, the demand for imports should rise less rapidly than during 1972. At the same time, economic growth in major industrial countries abroad is expected to be more rapid during 1973 than during 1972, and on this account the growth rate of demand for U.S. exports should show an improvement. Furthermore the slower rise in U.S. costs and prices relative to those experienced by our trading partners should increase the relative demand for U.S. products both at home and abroad. Finally, the positive long-run effect of the December 1971 currency realignment, which was offset by its perverse short-run effects on the nominal dollar value of our trade balance last year, can be expected to show up more clearly in 1973. However, the positive effects outlined above will be reduced by a continuing rise in net fuel imports.

Consumer Spending

Consumer spending is expected to rise approximately 9½ percent in 1973, exceeding last year's large rise of 8½ percent. However, the course of consumer demand within 1973 is not likely to be as rapid as it was within 1972. This difference between year-to-year and within-the-year movements reflects the fact that unlike 1972, the year 1973 starts off from a high base. For example, retail sales in December after seasonal adjustment were 4½ percent above the monthly average for all of 1972; the corresponding figure a year ago was 2½ percent above the 1971 average.

Personal income is expected to show another large gain from 1972 to 1973, with an expected rise close to that of last year. A large rise in employment and payrolls will be supplemented by the increase in social security benefits that became effective in the final quarter of 1972 as well as by new benefits that become effective in 1973.

Personal income is computed after subtracting personal contributions for social insurance. This year, increased social security tax rates and a higher taxable earnings base will reduce personal income by about $5 billion. Although the national income accounts record the entire amount of the tax rise beginning in the first quarter, it is important to note that the portion due to an increase in the wage base ($1.6 billion at an annual rate) does not, in actual practice, become effective until later in the calendar year.

Disposable income is expected to show an extremely large rise of 10 percent this year, exceeding the rise in personal income mainly because of the refunds of the overwithholding of 1972 personal income taxes. These refunds are expected to give a strong boost to cash income in the first half of the year, followed by a corresponding slowdown in the growth of spendable income after midyear. Some impact on consumption is expected from these refunds, but the greater part is assumed to affect personal saving, as seems to have been the case in 1972. Because of the heavy infusions of income in the first half of 1973, the saving rate in that period is likely to be very high but it should decrease as the year progresses.

Labor force and unemployment

The unemployment rate is expected to decline to the neighborhood of 4½ percent by the end of 1973. This projection is essentially based on the forecast that real GNP in 1973 will be about 6¾ percent higher than it averaged in 1972. The principal uncertainty involved in translating the projection of output into a projection of the unemployment rate is the growth of the total labor force (which includes the Armed Forces) over the course of the year.

In the mid-sixties it was widely assumed that the trend rate of growth of the labor force would rise to about 1¾ percent per annum and remain there through 1980. In fact the growth of the total labor force turned out to be much higher; over the last half of the 1960's it was close to 2¼ percent per annum. As a result, the total labor force is now far larger than the level projected in 1965. The extraordinary expansion in participation rates ended in 1970.

In 1972, in spite of a strong expansion in employment opportunities, the growth of the total labor force was close to its long-term rate of 1¾ percent. The uncertainty for 1973, and beyond, is whether labor force growth will remain at this level. There are reasons to believe that it will, and that the extraordinary increases between 1965 and 1970 represent a one-time phenomenon, caused principally by the following factors:

1. The strong demand for labor due to the Vietnam mobilization and buildup increased labor force participation rates. In particular it drew large numbers of women and teenagers into the labor force because so many men were either in the Armed Forces or remained in college.

2. The fertility rate fell rapidly, causing fewer women to be out of the labor force looking after young families.

3. Because women generally have a lower median age at marriage than men there was a temporary excess of women when the first cohorts of the postwar baby boom reached marriageable age in the mid-1960's. Like the fall in the fertility rate, the "marriage squeeze" induced an abnormal increase in the labor force.

4. The introduction of 7-day and late night openings by many sectors of retail trade led to large increases in the availability of part-time work.

These factors do not seem to be still operating on balance to accelerate participation rates further, and it is therefore likely that labor force growth will now remain at its long-run trend rate of 1¾ percent. If it does, and the size of the Armed Forces remains close to present levels, the 4½ percent unemployment level forecast should be achieved.

* * * * * * *

As always there are uncertainties. The projection of a 10 percent rise in money GNP between 1972 and 1973 is within the high side of the fairly narrow range being forecast by the majority of economic models and economists. The probability that GNP in 1973 will differ from its forecast value by more than 1 percent is extremely small.

The apparent consensus on money GNP for 1973 is due in part to the fact that many of the common foreshadowing data used are themselves stated in terms of expected dollar flows. There is less agreement about how the nominal increase will be divided between real growth and changes in the price level—because we have fewer insights on either of these components than we have for the total itself. The Council's projection of a 3 percent change in GNP prices is at the low end of the range now expected by private forecasters. It is based on three assumptions about the future: That the limit on federal expenditures proposed by the President for fiscal 1973 and fiscal 1974 will be met; that the rate of rise in food prices will be less than in 1972; that there will be a high degree of compliance with

Phase III standards, enforced as necessary by the Economic Stabilization Program. None of these is certain but the probability is high that all will be realized.

Notwithstanding the uncertainties, the economy in 1973 appears to be moving along a general path which gives it a better chance of reaching sustainable full employment than it has had in all but one or two years of the postwar period.

CHAPTER 4

The Economic Role of Women

ONE OF THE MOST important changes in the American economy in this century has been the increase in the proportion of women who work outside the home. This increase is the most striking aspect of the expansion of the role of women in the economy.

The addition of millions of women to the labor force has contributed substantially to the increase of total output. This is most obvious if we focus attention on the output that is measured and included in the gross national product (GNP). But even if we subtract from the contribution of working women to the GNP the value of the work they would have done at home, there has been an addition to total output. Most of the benefits of this additional output accrue to the women who produce it, and to their families. There are, however, also direct benefits to the society at large, including the taxes paid on the women's earnings.

Concern is sometimes expressed that the increase in women in the labor force will reduce the employment opportunities for men and raise their unemployment. There is no reason to think that would happen and there is no sign that it has happened. The work to be done is not a fixed total. As more women enter employment and earn incomes they or their families buy more goods and services which men and women are employed to produce. A sudden surge of entrants into the labor force might cause difficulties of adjustment and, consequently, unemployment, but the entry of women into the labor force has not been of that character.

Women work outside the home for the same reasons as men. The basic reason is to get the income that can be earned by working. Whether—for either men or women—work is done out of necessity or by choice is a question of definition. If working out of necessity means working in order to sustain biologically necessary conditions of life, probably a small proportion of all the hours of work done in the United States, by men or women, is necessary. If working out of necessity means working in order to obtain a standard of living which is felt by the worker to be desirable, probably almost all of the work done by both men and women is necessary.

The Employment Act of 1946 sets forth a goal of "maximum employment." We understand that to mean employment of those who want to work, without regard to whether their employment is, by some definition, necessary. This goal applies equally to men and to women. The Act also sets forth a goal of "maximum production." We understand the meaning of that goal which is relevant to the present context to be that people should be able to work in the employments in which they will be most productive. That also applies equally to men and women.

Although the goals apply equally to men and women, some of the obstacles to their achievement apply especially to women. Women have gained much more access to market employment than they used to have, but they have not gained full equality within the market in the choice of jobs, opportunities for advancement, and other matters related to employment and compensation. To some extent the cause of this discrepancy is direct discrimination. But it is also the result of more subtle and complex factors originating in cultural patterns that have grown up in most societies through the centuries. In either case, because the possibilities open to women are restricted, they are not always free to contribute a full measure of earnings to their families, to develop their talents fully, or to help achieve the national goal of "maximum production."

ADVISORY COMMITTEE ON THE ECONOMIC ROLE OF WOMEN

Recognizing the urgency of these problems and the importance of leadership to change the attitudes which underlie them, the President announced in September the formation of the Advisory Committee on the Economic Role of Women. The committee will meet periodically with the Chairman of the Council of Economic Advisers, providing a forum for the interchange of information, ideas, and points of view. This interchange will increase the Council's own expertise on the economics of women. Because the function of the Council of Economic Advisers is to advise the President on a wide variety of economic issues, its association with the committee will ensure that the interests of women will be represented in economic policy decisions.

With these goals in mind, in January 1973 the Chairman of the Council of Economic Advisers asked 21 men and women representing diverse areas of expertise to serve on the committee. They include officials from the Federal Government agencies whose activities are important to the progress of women, representatives from business, finance, education, and other private institutions, and specialists on the economic problems of women from sociology, psychology, economics, and the law. Among the topics that the committee will explore are job training and counseling in the schools, special problems of minority women, problems related to child care, women's performance at work, the extent of job discrimination, women's access to credit, and legislative action on taxes and social security that may have a different effect on women than on men.

Another, more fundamental, issue affecting women in the economy underlies many of the others. The roles played by women and men have been sharply differentiated. It is obvious that only women are capable of childbearing. But along with this biologically determined role, women have by tradition come to assume primary responsibility for child care and home management, while men have primary responsibility for the family's financial support. Until very recently this division of labor within the family has had such general acceptance as to impose limitations on women's work outside the home. The way in which the economic role of women evolves thus hinges on the most fundamental societal patterns, and the extent to which social action can and should influence further change in these patterns will be one of the most difficult and important questions the committee must consider.

By way of an introduction to the problem, this chapter looks at job-related aspects of the economic role of women. The committee will, of course, deal with a much broader range of topics.

PARTICIPATION IN THE LABOR FORCE

In 1900 about 20 percent of all women were in the work force (Table 21). In the succeeding decades this percentage hardly increased, reaching about 25 percent by 1940. With World War II, however, the movement rapidly accelerated, and by 1972 the percentage of women 16 years and older in the work force had risen to 43.8. Single women and women widowed, divorced, or separated, have always had higher labor force participation rates than married women living with their husbands. By 1950, the participation of women in the two former groups had already reached levels close to those of today. Thus, the upward trend in labor force participation since World War II has been due almost entirely to the

TABLE 21.—*Women in the labor force, selected years, 1900-72*

Year	Women in labor force (thousands)	Women in labor force as percent of	
		Total labor force	All women of working age
1900	5,114	18.1	20.4
1910	7,889	20.9	25.2
1920	8,430	20.4	23.3
1930	10,679	22.0	24.3
1940	12,845	24.3	25.4
1945	19,270	29.6	35.7
1950	18,412	28.8	33.9
1955	20,584	30.2	35.7
1960	23,272	32.3	37.8
1965	26,232	34.0	39.3
1970	31,560	36.7	43.4
1972	33,320	37.4	43.8

Note.—Data for 1900 to 1940 are from decennial censuses and refer to a single date; beginning 1945 data are annual averages.

For 1900 to 1945 data include women 14 years of age and over; beginning 1950 data include women 16 years of age and over.

Labor force data for 1900 to 1930 refer to gainfully employed workers.

Data for 1972 reflect adjustments to 1970 Census benchmarks.

Sources: Department of Commerce, Bureau of the Census, and Department of Labor, Bureau of Labor Statistics.

changed behavior of married women (Table 22). The first to respond were the more mature married women beyond the usual childbearing years. More recently there has also been a sharp upturn in the labor force participation of younger married women.

The record for men has tended to run in the opposite direction. A secular reduction in time spent in paid work over most men's lifetimes has taken place: A man spends more years at school and enters the labor force later than formerly; he retires earlier, works fewer hours a week, and has longer vacations. Of course these changes have also affected women, but for them the increase in years worked has far outweighed the other work-reducing factors.

In one very important respect, however, the working life patterns of men and women have not merged. The typical man can expect to be in the labor force continuously, for an unbroken block of some 40 years between leaving school and retirement. Of men in the 25–54 year age group, 95.2 percent were in the labor force in 1972. For most women, this continuity in participation is the exception rather than the rule.

TABLE 22.—*Labor force participation rates of women by marital status and age, 1950, 1960 and 1972*

[Percent [1]]

Marital status and year	Total	Age					
		Under 20 years	20–24 years	25–34 years	35–44 years	45–64 years	65 years and over
Single:							
1950	50.5	26.3	74.9	84.6	83.6	70.6	23.8
1960	44.1	25.3	73.4	79.9	79.7	75.1	21.6
1972	54.9	41.9	69.9	84.7	71.5	71.0	19.0
Married, husband present:							
1950	23.8	24.0	28.5	23.8	28.5	21.8	6.4
1960	30.5	25.3	30.0	27.7	36.2	34.2	5.9
1972	41.5	39.0	48.5	41.3	48.6	44.2	7.3
Widowed, divorced, or separated:							
1950	37.8	(2)	45.5	62.3	65.4	50.2	8.8
1960	40.0	37.3	54.6	55.5	67.4	58.3	11.0
1972	40.1	44.6	57.6	62.1	71.7	61.1	9.8

[1] Labor force as percent of noninstitutional population in group specified.
[2] Not available.

Note.—Data relate to March of each year.
Data for 1950 and 1960 are for women 14 years of age and over; data for 1972 are for women 16 years of age and over.

Source: Department of Labor, Bureau of Labor Statistics.

THE HISTORICAL PATTERN

What are the causal factors that induced women to enter the labor force? One might have expected that the strong increases in husbands' real incomes which occurred during the period would have provided an incentive to women not to enter the labor force. This seeming puzzle is resolved, however, when one considers that by entering the labor force women did not leave a life of leisure for work, but rather changed from one kind of work, work at home, to another kind of work, work in the market. The incentive for women to make this dramatic occupational change came from several developments which made paid work outside the home the increasingly more profitable alternative.

Rapidly rising earnings and expanded job opportunities for women gave a strong impetus to the change. The expansion of job opportunities for women was undoubtedly influenced by the expansion of the service sector of the economy, where employment increased by 77 percent from 1950 to 1970, compared to the increase of 26 percent in the goods-producing industrial sector over the same period. Women have always been more heavily represented in services than in industry, since the service sector offers more white-collar employment and provides more opportunities for part-time work, an especially important feature for women with small children. On the other hand, the increasing supply of women workers perhaps itself contributed to the rapid expansion in the service sector.

The increase in women's educational attainments has also helped to raise the amount they can earn by working. Education may make women more productive in the home, that is, more efficient housekeepers, consumers, and mothers, but education appears to increase still more their productivity in work outside the home. Women with more education earn more, and they are more likely than less educated women to seek work in the market.

Because life expectancy has increased considerably over the century (and more for women than for men), and because most women complete their childbearing at a younger age, women can look forward with more certainty to a longer uninterrupted span of years in the labor force. This lengthening of a woman's expected working life is significant because it increases her return on her investment in training and education: the greater the number of years in which to collect the return the greater is the return.

These increases in the income a woman could potentially earn meant essentially that time spent producing goods and services at home was coming at a higher and higher cost in terms of the income foregone by not working in the market. It made sense then to buy available capital equipment (such as washing machines) which would substitute for some of the housewife's time and free her to go to work. And changes in technology which lowered the cost and increased the array of time-saving devices facilitated the substitution.

The most difficult home responsibility to find a good substitute for is child care; and, although the labor force participation of women with children under 6 years has increased from 12 percent in 1950 to 30 percent in 1971, child-rearing is probably the major factor causing some women to interrupt and others to curtail their careers.

The long-term decline in the average number of children in the family has undoubtedly had a strong influence on the proportion of women entering the labor force. Advances in birth control techniques permit parents not only to reduce the number of births but also to control their timing to

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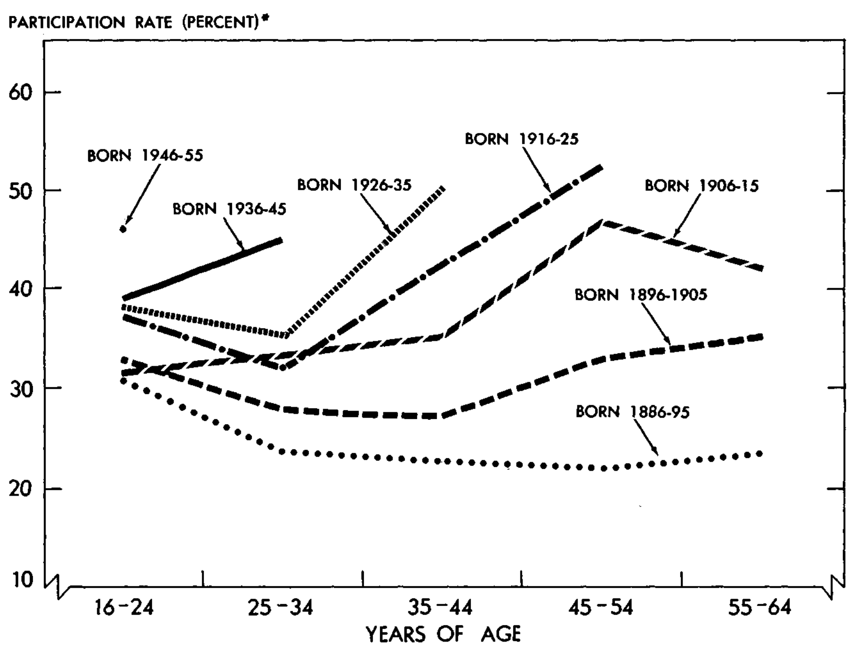
suit a mother's working career. Declines in infant and child mortality may also have encouraged a reduction in births by increasing the parents' expectation that all their children would survive to adulthood. On the other hand, reductions in family size may themselves be influenced by the desire of women to work.

Childbearing has a very noticeable effect on the patterns of women's labor force participation by age. Based on census data, Chart 9 traces the lifetime changes in labor force participation by groups of women born at different times, the earliest group consisting of women born between 1886 and 1895. The chart therefore simulates the actual work history of particular cohorts of women followed longitudinally. According to this chart, the various forces in the economy that have induced women to work have generally had a more powerful effect on women beyond the childbearing ages

Chart 9

Labor Force Participation Over a Working Life of Cohorts of Women Born in Selected Time Intervals, 1886-1955



*TOTAL LABOR FORCE AS PERCENT OF TOTAL NONINSTITUTIONAL POPULATION IN GROUP SPECIFIED.

NOTE: FOR WOMEN BORN BETWEEN 1886 AND 1915, THE FIRST AGE PLOTTED IS 14-24 YEARS. COHORTS REACH EACH AGE INTERVAL ACCORDING TO THE MIDPOINT OF THEIR BIRTH YEARS. THUS, THE COHORT BORN 1886-95 REACHED AGES 25-34 IN 1920 AND AGES 55-64 IN 1950; THE COHORT BORN 1916-25 REACHED AGES 25-34 IN 1950 AND AGES 45-54 IN 1970.

SOURCE: DEPARTMENT OF COMMERCE.

than on younger groups. Those increases in labor force participation that have occurred for groups of women reaching the childbearing ages of 20–34 years have been closely associated with declining fertility rates. Thus labor force participation for the group reaching 25–34 years increased substantially from 1930 to 1940, and again between 1960 and 1970, while there was a decline between 1940 and 1950 in the participation of those reaching this age group—the baby boom mothers. Whether the young women now in their twenties have simply postponed having children and will later drop out of the labor force or whether many will continue to work, choosing to have small families or remain childless is, of course, a question of great interest.

THE WORKING WOMAN TODAY

Although the decisions of individual women to work outside the home are undoubtedly based on many different factors, there are some economic factors which seem to be of overriding importance. The necessity to support oneself or others is one obvious reason and, not surprisingly, adult single women and women who have been separated from husbands or widowed are highly likely to work.

The increase in earnings opportunities, which proved to be such a powerful factor influencing the secular growth of women's participation in the labor force, is a similarly powerful factor influencing the pattern of women's participation at any given time. Thus, education and other training which affect the amount a woman can earn are strongly related to women's work patterns. The importance of education is such that, whether a woman is single, married or separated, the more education she has, the more likely she is to work. One striking exception to this pattern is that, among mothers of children under 6 years old, there is scarcely any relation between education and labor force participation. Thus, the rearing of children of preschool age causes all women, regardless of education, to curtail their work outside the home. However, the drop in participation during this child-rearing period is most pronounced for highly educated women who in other circumstances have much higher participation rates.

Although for most women the childbearing period has been reduced, childbearing still means an interruption of outside work. A longitudinal survey of the lifelong work experience of women indicates that among all women who were 30–44 years old in 1967, only 7 percent had worked at least 6 months out of every year since leaving school. Among married women with children the proportion was still lower, dropping to 3 percent. By contrast, 30 percent of childless married women in the same group had worked at least 6 months out of every year. Information on job tenure collected by the Bureau of Labor Statistics illustrates much the same phenomenon. As of January 1968, continuous employment in their current job came to 2.4 years (the median) for women and 4.8 years for men. Job tenure increases with age for both men and women. At ages 45 and over the median was 12.7 years for men and 6.6 years for women. Since women tend to change jobs less frequently than men, their shorter time spent on any given job is the result of a higher propensity to leave the labor force at least temporarily. In 1964 a survey of women who had dropped out of the labor force in 1962 or 1963 and had not yet reentered was undertaken by the Labor Department in an effort to find out why they had left. Pregnancy was most frequently cited as the primary reason—by 74 percent of the 18- to 24-year-olds and 56 percent of the 25- to 34-year-olds.

Among married women, husband's income does not have a very pronounced effect on work patterns. The median annual income of husbands with working wives was $8,070 in 1971 compared to $8,330 for husbands of wives not in the labor force. Only when husbands' incomes reach the $10,000 and over category does wives' participation decline to any noticeable extent. However, many other things vary with husbands' incomes, such as wives' education and age as well as family size. These other factors are sufficiently important to obscure the simple relation between husband's income and a wife's tendency to work. It should be noted, however, that during a time of hardship, such as when a husband experiences a prolonged spell of unemployment, wives who usually do not work may be compelled to work. Thus, the labor force participation of women with unemployed husbands is generally above that of women with employed husbands.

Although the probability that a black woman will work seems to vary with education and presence of children in much the same way as it does for all women, there is one very striking difference: the labor force participation of black women is higher. Particularly pronounced differences are observed when the comparison of labor force participation is confined to married women living with their husbands. In March 1971, about 53 percent of black wives were in the labor force compared to 40 percent of white wives. One important reason why this difference prevails may be that the earnings of black wives are closer to their husbands' than is the case among white married couples. In 1971 black married women who worked year-round, full-time earned 73 percent as much as black married men who worked year-round, full-time. Among whites the percentage was only 51 percent. Behind these relationships is the fact that black men earn considerably less than white men, while black women's earnings are much closer to white women's earnings.

UNEMPLOYMENT

Women have generally experienced more unemployment than men and this differential has been more pronounced in recent years (Table 23). However, the source of women's unemployment differs from that of men's, and this makes a comparison of unemployment differences more complex than might appear.

TABLE 23.—*Unemployment rates by sex and age, selected years, 1956–72*

[Percent [1]]

Sex and age	1956	1961	1965	1969	1972
All workers	4.1	6.7	4.5	3.5	5.6
Men	3.8	6.4	4.0	2.8	4.9
16–19 years	11.1	17.1	14.1	11.4	15.9
20–24 years	6.9	10.8	6.4	5.1	9.2
25–54 years	3.0	5.1	2.7	1.6	3.1
55 years and over	3.5	5.7	3.3	1.9	3.3
Women	4.9	7.2	5.5	4.7	6.6
16–19 years	11.2	16.3	15.7	13.3	16.7
20–24 years	6.3	9.8	7.3	6.3	9.3
25–54 years	4.1	6.2	4.3	3.5	4.9
55 years and over	3.3	4.4	2.8	2.2	3.4

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

Source: Department of Labor, Bureau of Labor Statistics.

Some of the difference arises from the way people are classified in our unemployment statistics. A person with a job is not classified as unemployed even though he or she may be searching for another job. However, work at home is not counted as a job. Thus, a woman who may in a real sense be clearly employed in the home while she searches for a job, will be counted as unemployed, unlike the man who searches while on his job.

Most adult men are continuously in the labor force and therefore become unemployed because they have either quit or lost their jobs (Table 24). For women, the picture is different: labor force participation is frequently interrupted, sometimes for several years, but sometimes just for several weeks during the year. Thus, although 59.8 percent of the women 24–54 years old were in the labor force at one time or another during 1971, only 38.2 percent were in the labor force for 50–52 weeks during the year. This high rate of labor force turnover generates unemployment, and it is not surprising to find that in both the tight labor market of 1969 and the looser labor market of 1972 a considerable portion of unemployed women were

TABLE 24.—*Distribution of unemployment of adult men and women by reason for unemployment, 1969 and 1972*

[Percent]

Reason for unemployment	Men 20 years and over		Women 20 years and over	
	1969	1972	1969	1972
Total unemployment	100.0	100.0	100.0	100.0
Separated from a job	74.8	75.3	49.9	55.7
Job losers	57.8	62.6	33.0	39.4
Job leavers	17.0	12.7	16.8	16.3
Labor force entrants	25.2	24.6	50.2	44.3
Reentrants	22.4	21.6	44.8	39.4
New entrants	2.8	3.1	5.5	4.9
Unemployment rate	2.1	4.0	3.7	5.4

Note.—Detail may not add to totals because of rounding.

Source: Department of Labor, Bureau of Labor Statistics.

labor force entrants (Table 24). People entering or reentering the labor force tend, however, to be unemployed for relatively short periods, and this is one of the reasons why the duration of unemployment is in general shorter for women than for men (Table 25).

Table 25.—*Unemployment of adult men and women by duration and reason, 1972*

Sex, age, and reason	Total unemployment (thousands)	Percent of total unemployment	
		Unemployment of less than 5 weeks	Unemployment of 15 weeks and over
Men 20 years and over	1,928	37.0	31.6
Lost last job	1,207	33.6	35.3
Left last job	245	44.9	24.9
Reentered labor force	416	41.7	25.4
Never worked before	59	39,0	28.8
Women 20 years and over	1,610	48.4	22.8
Lost last job	635	35.6	33.4
Left last job	262	50.0	19.2
Reentered labor force	635	59.8	14.4
Never worked before	79	55.7	16.5

Note.—Detail may not add to totals because of rounding.

Source: Department of Labor, Bureau of Labor Statistics.

In order to know what significance to attach to the observation that the greater unemployment of women appears to be related to their greater labor force turnover, it is of course necessary to know more about the causes of the turnover. Some have stressed that excessive labor force turnover indicates a poor job market. According to this view, women drop out of the labor market because lack of opportunities has discouraged them from continuing the search. Evidence for this point of view is cited from Labor Department surveys, which indicate that some of those women out of the labor force are there because they do not believe they could find work. In 1972, 525,000 women or 1.2 percent of those out of the labor force were reported in this category.

Another school of thought, however, stresses that the labor force turnover of women and the unemployment it generates is largely induced by factors external to the current labor market, such as the uneven pressures of home responsibilities. Several kinds of evidence support this point of view. Unemployment among women appears to be related to the nature of home responsibilities. For example, in 1971 the unemployment rate for married women with children under 3 years was 11.7 percent, compared to the rate of 4.5 percent for married women with no children under 18 years. Moreover, on numerous surveys women cite pregnancy, home responsibilities, or husband's relocation as primary reasons for leaving the job or the labor force.

It would of course be interesting to know more about the unemployment experience of women who do remain continuously in the labor force. Some evidence from the Labor Department's longitudinal survey indicates that women who were in the labor force in both 1967 and 1969 had considerably lower unemployment in 1969 than those who were in the labor force in 1969 but not in 1967. The unemployment rate in 1969 for the group who were also in the labor force 2 years previously was 2.9 percent, compared to the rate of 6.9 percent for the women who were in the labor force only in 1969. However, this was still above the rate of 2.1 percent for men 20 years old and over in 1969, as measured by the household survey.

Although movement in and out of the labor force is probably the most important factor leading to higher unemployment for women compared to men, two other factors seem to be important. Women with less time on a job and in whom the employer had made negligible training investments are more vulnerable to layoffs. Finally, one additional factor which doubtless contributes to unemployment of married women is the difficulty in maximizing employment opportunities for both the husband and the wife. A wife seldom is free to migrate to wherever her own prospects are best.

It is important to emphasize, because the point is often misunderstood, that to explain the unemployment of women is not to excuse it or belittle it or to place blame on the women who are unemployed. The unemployment of women who seek work is costly, to themselves, their families, and the Nation. Our goal should be to reduce this unemployment wherever that can be done by means which are not themselves more costly. Some unemployment entails more loss for the workers involved and to the economy as a whole than other; some is more amenable to correction by the persons directly affected than other unemployment. But these distinctions do not run along sex lines.

THE WIDENING IN THE REPORTED MALE-FEMALE UNEMPLOYMENT DIFFERENTIAL

During the 1960's the differential in reported unemployment between women and men widened. Two factors may help to explain the change. The first has to do with changes in the unemployment survey questionnaire introduced in 1967.

Persons are classified as unemployed if they have not worked during the survey week, were available to work during the survey week, and had made specific efforts to find a job such as looking in the "want-ads" section of the newspaper or going to an employment agency. Prior to 1967 the period of jobseeking efforts was not specified, and it is believed that many respondents interpreted the question narrowly to mean that one had to have looked for a job in the week just prior to the survey. In 1967 the unemployment question was changed by specifying 4 weeks preceding the survey as the point of reference. Data from samples taken on both the old and new basis are available for 1966. In that year the unemployment rate for women aged 20 years or older was 0.4 percentage points higher on the new basis than on the old. This increase in the rate for women as a result of the change in the questionnaire has been interpreted as reflecting the likelihood that the jobseeking activities of women are more intermittent. As a result of lengthening the reference period to 4 weeks, persons who had briefly looked for work but who were not actively seeking work by the time of the survey week would be added to the unemployed under the new definition.

Although the reported unemployment of some men may also have been increased as a result of the effective lengthening of the unemployment reference period, other changes in the questionnaire in 1967, which were evidently unimportant for women, seemed to reduce the reported unemployment of men. Indeed these changes were of sufficient importance that the net effect was to lower the unemployment rate for men 20 years old and over by 0.3 percentage points. The unemployment rate for men was evidently lowered for two reasons: By a reclassification from unemployed to employed of persons absent from work because of a vacation or a labor dispute but at the same time looking for work; and by the fact that persons stating that they had given up the search for work were no longer counted as unemployed.

The 1966 samples indicate that as a result of the changes in the unemployment questionnaire, which increased the rate for women and lowered the rate for men, the reported male-female unemployment differential, comparing men and women 20 years old and over, increased from 1.3 percentage points to 2.0 percentage points. We cannot, of course, be sure that effects of the same precise magnitude have persisted ever since the new definitions were substituted in 1967. However, the definitional change has undoubtedly contributed to a wider unemployment differential since the late 1960's.

Another factor contributing to the widening of the unemployment differential may be the rapid increase in the labor force participation of women during the 1960's, since its effect was to increase the proportion of women entering or reentering the labor force, with an accompanying increase in unemployment.

EDUCATION AND THE OCCUPATIONAL DISTRIBUTION

Some of the hesitancy of women to enter or to stay in the labor force is undoubtedly the result of societally determined factors that restrict the possibilities open to them. The low representation of women in positions of responsibility is striking. Despite gradual gains, progress has not been sufficient to alter the picture significantly (Table 26). Exactly how much of this situation has been imposed on women because of prejudice and how much of it derives from a voluntary adjustment to a life divided between home responsibilities and work remains obscure. The existence of discriminatory

TABLE 26.—*Women as a percent of persons in several professional and managerial occupations, 1910–70*

[Percent]

Occupational group	1910	1920	1930	1940	1950	1960	1970
Clergymen	0.6	1.4	2.2	2.4	4.0	2.3	2.9
College presidents, professors, and instructors [1]	18.9	30.2	31.9	26.5	23.2	24.2	28.2
Dentists	3.1	3.3	1.9	1.5	2.7	2.3	3.5
Editors and reporters	12.2	16.8	24.0	25.0	32.0	36.6	40.6
Engineers	(2)	(2)	(2)	.4	1.2	.8	1.6
Lawyers and judges	.5	1.4	2.1	2.5	3.5	3.5	4.9
Managers, manufacturing industries	1.7	3.1	3.2	4.3	6.4	7.1	6.3
Physicians	6.0	5.0	4.4	4.7	6.1	6.9	9.3

[1] Data for 1920 and 1930 probably include some teachers in schools below collegiate rank. The Office of Education estimates the 1930 figure closer to 28 percent.
[2] Less than one tenth of 1 percent.

Note.—Data are from the decennial censuses. Data for 1910 and 1920 include persons 10 years of age and over; data for 1930 to 1970 include persons 14 years of age and over.

Source: Department of Commerce, Bureau of the Census.

barriers may discourage women from seeking the training or adopting the life style it would take to achieve a responsible and highly demanding job. On the other hand, women who expect to marry and have children and who also put their role at home first are subject to considerable uncertainty about their future attachment to the labor force. In the latter case, incentives to train extensively for a career would be few; and, once such women started working, the restrictions imposed by home responsibilities could limit their ability to take a job requiring long hours or the intensive commitment that most high-status positions demand. At the same time, changes in the accepted social roles of men and women would alter current patterns if they changed women's expectations about their future in the labor force.

For whatever reasons, from school onward the career orientation of women differs strikingly from that of men. Most women do not have as strong a vocational emphasis in their schooling; and for those who do, the preparation is usually for a stereotyped "female" occupation.

Although the probability of graduating from high school has been somewhat greater for women than for men, it is less probable that a woman will complete college, and still less that she will enter graduate school. The representation of women consequently declines as they move upward through the stages of education beyond high school. In 1971, 50 percent of all high school graduates were women and 45 percent of first-year college students were women. During 1971 women earned 44 percent of the bachelor's degrees granted, 40 percent of the master's degrees, and 14 percent of the doctorates.

Even more striking are the differences in the courses taken. At both the undergraduate and advanced levels, women are heavily represented in English, languages, and fine arts—the more general cultural fields. They are poorly represented in disciplines having a strong vocational emphasis and promising a high pecuniary return. In 1970, 9.3 percent of the baccalaureates in business and 3.9 percent of the master's in business went to women.

In the biological sciences, women had a larger share, taking about 30 percent of the bachelor's and master's degrees and 16 percent of the doctorates. But only 8.5 percent of the M.D.'s and 5.6 percent of the law degrees went to women. Most of these percentages, low as they are, represent large gains from the preceding year.

The situation is quite different in the so-called women's occupations. In 1971 women received 74 percent of the B.A.'s and 56 percent of the M.A.'s given in education. In library science, which is even more firmly dominated by women, they received 82 percent of all degrees in 1971. And in nursing, 98 percent of all the degrees went to women.

It is not surprising, then, to find that women do not have anything like the same occupational distribution as men. Even within an educational level, significant differences remain in the distribution across broad occupational categories (Table 27). Although 77 percent of women college graduates in 1970 were in the professions, mostly as teachers, only 4.8 percent, compared to 20 percent for men, were classified as managers. At high school levels, the proportion of women working as skilled craftsmen is minuscule, although a substantial proportion of women are blue-collar workers in the lower paying operative categories.

The supplement to this chapter, appearing in Appendix A, summarizes in detail women's representation in occupations more narrowly defined. Although women are found in all occupations, the extent of occupational segregation by sex is large. In broad outline, this situation does not appear to have undergone any dramatic change between 1950 and 1970, although there are several examples of large increases in the proportion of women in less typically "female" occupations (for example busdrivers, bartenders, and compositors and typesetters).

TABLE 27.—*Occupational distribution of employed persons by education and sex, 1970*

[Percent]

Occupational groups	High school				College graduates	
	1–3 years		4 years		Men	Women
	Men	Women	Men	Women		
Total employed	100.0	100.0	100.0	100.0	100.0	100.0
Professional, technical, and kindred workers	2.8	3.6	7.6	7.1	58.9	77.4
Managers and proprietors	6.9	2.9	11.4	3.8	20.1	4.8
Salesworkers	5.6	10.2	7.5	8.1	8.6	2.3
Clerical and kindred workers	6.8	25.3	10.0	50.4	4.9	12.1
Craftsmen	25.6	2.4	26.4	1.8	3.3	.4
Operatives	27.3	22.5	20.6	11.4	1.4	.6
Nonfarm laborers	9.9	1.6	5.3	.8	.5	.1
Farm laborers and foremen	1.9	.6	.9	.3	.2	.1
Farmers and farm managers	2.2	.2	2.9	.2	.8	.1
Service workers excluding private household	10.8	25.4	7.5	14.5	1.4	1.9
Private household service workers	.2	5.2	(1)	1.7	(1)	.3

[1] Less than one tenth of 1 percent.

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce, Bureau of the Census.

Casual observation of individual occupations cannot, of course, provide a comprehensive indication of whether the occupational distributions of men and women, involving numerous occupations, have moved closer together or further apart. To help answer this question, an index was constructed and calculated for 1960 and 1970 which reflects the difference (for 197 occupations) between the occupational distributions of men and women. The index displays a small move toward occupational similarity between 1960 and 1970. (See the supplement to this chapter, included in Appendix A, for a more detailed description of the index.)

Another question of interest is whether the changes in the occupational distributions of men and women were in the direction of higher economic status and, if so, how far they went. Some insight into this question is obtained by calculating an index which reflects what earnings would have been in 1950, 1960, and 1970, if earnings were the same in all 3 years and only the occupational distributions changed. Median earnings for year-round, full-time workers in each of 11 broad occupational categories were used as the constant weights to calculate such an index. The results indicated that the occupational distributions of both men and women shifted in the direction of higher-earnings occupations from 1950 to 1960 and from 1960 to 1970. However, in the earlier period men moved ahead in this respect faster than women while in the second period the changes were similar for both.

EARNINGS

In 1971 annual median earnings for women 14 years old and over were $2,986, or 40 percent of the median earnings of men. But women work fewer hours per week and fewer weeks per year. If the comparison is restricted to year-round, full-time workers, women's earnings are 60 percent of men's, that is, $5,593 compared to $9,399. An additional adjustment for differences in the average full-time workweek—full-time hours for men were about 10 percent higher than for women—brings the female-male ratio to 66 percent in 1971.

Differentials of this order of magnitude appear to have persisted since 1956 (Table 28). Indeed, a slight increase in the differential seems to have occurred from 1956 to 1969. Part of the source of the increasing differential was the relatively low rate of growth in the earnings of female clerical workers and female operatives, who in 1970 accounted for 32 percent and 14 percent, respectively, of all women workers. On the other hand, the rate of growth of earnings of women in the professions was high (a 5.1-percent annual compound rate between 1955 and 1968) relative to all workers; more recently it was even high relative to male professionals.

TABLE 28.—*Ratio of total money earnings of civilian women workers to earnings of civilian men workers, selected years, 1956–71*

Occupational group	Actual ratios					Adjusted ratios [1]	
	1956	1960	1965	1969	1971	1969	1971
Total [2]	63.3	60.7	59.9	58.9	59.5	65.9	66.1
Professional and technical workers	62.4	61.3	65.2	62.2	66.4	67.9	72.4
Teachers, primary and secondary schools	(3)	75.6	79.9	72.4	82.0	(3)	(3)
Managers, officials, and proprietors	59.1	52.9	53.2	53.1	53.0	57.2	56.8
Clerical workers	71.7	67.6	67.2	65.0	62.4	70.0	66.9
Sales workers	41.8	40.9	40.5	40.2	42.1	45.7	47.4
Craftsmen and foreman	(4)	(4)	56.7	56.7	56.4	60.8	60.2
Operatives	62.1	59.4	56.6	58.7	60.5	65.4	66.6
Service workers excluding private household workers	55.4	57.2	55.4	57.4	58.5	62.5	63.2

[1] Adjusted for differences in average full-time hours worked since full-time hours for women are typically less than full-time hours for men.
[2] Total includes occupational groups not shown separately.
[3] Not available.
[4] Base too small to be statistically significant.

Note.—Data relate to civilian workers who are employed full-time, year-round. Data for 1956 include salaried workers only, while data for later years include both salaried and self-employed workers.

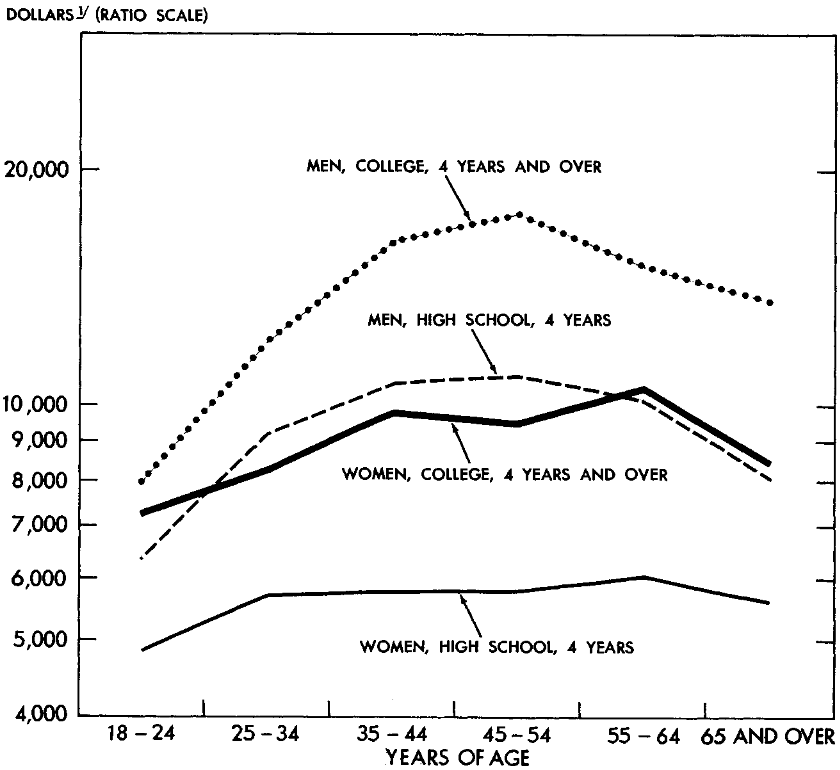
Sources: Department of Commerce, Bureau of the Census, Department of Labor, Bureau of Labor Statistics, and Council of Economic Advisers.

A large differential is also evident when the comparison is restricted to men and women of the same age and education. As Chart 10 indicates, the incomes of women do not increase with age in anything like the same way men's do. Thus the differential widens with age through much of the working life.

One important factor influencing the differential is experience. The lack of continuity in women's attachment to the labor force means that they will not have accumulated as much experience as men at a given age. The relatively steeper rise of men's income with age has been attributed to their greater accumulation of experience, of "human capital" acquired on the job. Since very few women have participated in the labor force to the same degree as men, it is difficult to set up direct comparisons between the earnings of men and women with the same lifetime pattern of work. Using data from the Labor Department's longitudinal study of women, referred to above, one study was able to compare the earnings of women working different amounts of time throughout their lives with the earnings of men, most of whom are presumed to work continuously after leaving school. The figures for men were taken from census data. The women's lifetime work experience was measured as the percentage of years each had worked since leaving school. However, a work year was crudely defined as one in which the women had worked at least 6 months. Thus no adjustment could be made for whether the years worked had been truly full-time commitments with respect to both hours worked per week and weeks worked per year.

Chart 10

Annual Income by Age, for Male and Female High School and College Graduates



1/ MEDIAN INCOME OF FULL-TIME, YEAR-ROUND WORKERS, 1971.
SOURCE: DEPARTMENT OF COMMERCE.

Among the women 30–44 years old in the survey, the gain from continuous work was apparently very large. If we look only at those women who had worked year-round, full-time in 1966, the median wage and salary income for the group who had worked each year since leaving school was $5,618; for those who had worked less than 50 percent of the years since leaving school (almost half the group) the median income was $3,655. The median wage and salary income of men in the same age group who had worked full-time, year-round in 1966 was $7,529. The men are presumed to have worked continuously since leaving school. Thus the women who had worked less than half of the years since leaving school earned only 49 percent as much as men, while the small group of women who had worked each year earned 75 percent as much as men. Interestingly, single women who had worked each year since leaving school earned slightly more than single men. More sophisticated comparisons, adjusting for additional differences in training, continuity at work, and education, can be made. One recent study found that the earnings differential was reduced to below 20 percent after taking account of such differences.

The importance of lifetime accumulated experience in influencing women's earnings suggests one possible explanation for the small decline in the ratio of women's to men's earnings between 1956 and 1969. Since the labor force participation of women has been rising rapidly, an increasing proportion of new entrants and of those with few accumulated years in the labor force could have resulted in a decline in the average experience level of all women. This drop would in turn temporarily push down the average level of earnings for all women. Unfortunately the data are not available to compare the ratio over a period of time between the earnings of women having a given number of years' experience and the earnings of men.

DIRECT DISCRIMINATION VERSUS ROLE DIFFERENTIATION

A differential, perhaps on the order of 20 percent, between the earnings of men and women remains after adjusting for factors such as education, work experience during the year, and even lifelong work experience. How much of this differential is due to differences in experience or in performance on the job which could not be measured adequately, and how much to discrimination? The question is difficult to answer, in part because there are differences of opinion about what should be classified as discrimination.

Some studies have succeeded in narrowing the male-female differential well below 20 percent. Indeed, Department of Labor surveys have found that the differential almost disappears when men's and women's earnings are compared within detailed job classifications and within the same establishment. In the very narrow sense of equal pay for the same job in the same plant there may be little difference between women and men. However, in this way the focus of the problem is shifted but not eliminated, for then we must explain why women have such a different job structure from men and why they are employed in different types of establishments.

There is clearly prejudice against women engaging in particular activities. Some patients reject women doctors, some clients reject women lawyers, some customers reject automobile saleswomen, and some workers reject women bosses. Employers also may have formulated discriminatory attitudes about women, exaggerating the risk of job instability or client acceptance and therefore excluding women from on-the-job training which would advance their careers.

In fact, even if employers do estimate correctly the average job turnover of women, women who are strongly committed to their jobs may suffer from "statistical discrimination" by being treated as though their own behavior resembled the average. The extent to which this type of discrimination occurs depends on how costly it is for employers to distinguish women who will have a strong job commitment from those who will not. Finally, because some occupations restrict the number of newcomers they take in and because women move in and out of the labor force more often, more women than men tend to fall into the newcomer category and to be thus excluded. For example, restrictive entry policies may have kept women out of the skilled crafts.

On the other hand, as discussed above, some component of the earnings differential and of the occupational differential stems from differences in role orientation which start with differences in education and continue through marriage, where women generally are expected to assume primary responsibility for the home and subordinate their own outside work to their household responsibilities.

It is not now possible to distinguish in a quantitative way between the discrimination which bars women from jobs solely because of their sex, and the role differentiation whereby women, either through choice or necessity, restrict their careers because of the demands of their homes. Some may label the latter as a pervasive societal discrimination which starts in the cradle; nonetheless, it is useful to draw the distinction.

One other missing link in our chain of understanding of these problems is the value of the work done at home by women. One study has found that women college graduates tend to reduce their outside work when their children are small more than less educated women, and that they also devote more time to the training of their children. Of course this pattern is undoubtedly facilitated by the higher income of their husbands. However, this pattern also results in a considerable sacrifice of earnings, and one may infer that these women have therefore placed a very high value on the personal attention they can give their children. Without more information, it is difficult to evaluate the full extent to which women's capabilities have actually been underutilized by society.

SPECIAL PROBLEMS

THE FEMALE-HEADED HOUSEHOLD

In 1971, some 6 million families, about 11.5 percent of all families, were headed by women. These women are widowed, divorced, separated, or single, and many have responsibilities for the support of children in fatherless families or of other relatives. Close to two-thirds of all female-headed families include children; the average number of children under 18 years of age in a female-headed family with children was about 2.3 in 1971, about the same as in male-headed families with children.

As a result of the division of labor within families, the average woman who has been married has not had the same labor market experience or vocationally oriented training as her husband. Unless she has a substantial alimony or pension, she is likely to face financial difficulties. The median income of female-headed families was $5,116 in 1971, less than half the income of male-headed families ($10,930). When women who head families were full-time, year-round workers, the family's median income was $7,916; but only 32 percent of women heading families were able to be full-time, year-round workers. And the woman who heads a family and works has additional expenses of child care and other home care expenses.

The problems faced by the woman who heads a household are particularly acute if the woman is black, and 27 percent of women heading households are black. For this group, median family income was only $3,645 in 1971. Although, at higher education levels, black women now earn amounts comparable to white women, those black women who head families are at a disadvantage compared to white women. The median personal income of white women heading households and working year-round, full-time was $6,527 in 1971, compared to $5,227 for black women in the same position.

As a result of the combination of a large number of dependents and the difficulty of maintaining the dual responsibility of monetary support and home care, many female-headed families fall below the low-income level. In 1971, 34 percent of female-headed families were below the low-income level, compared to 7 percent for male-headed families. Among black households with a female head, 54 percent were below the low-income level. A large proportion receive public assistance. In 1971, 30 percent of the women heading households received public assistance payments.

It has been suggested, though not proved, that widespread availability of public assistance has encouraged husbands to desert their wives or wives to leave their husbands in families where the husband earns little more than the amount of welfare benefits his family would be entitled to in his absence. Remarriage may also be discouraged because the low-income mother would then lose her entire public stipend, including the child support portion, and without some outside child support a man might be reluctant to marry a woman with several children.

Among the women who are now welfare recipients many are handicapped by lack of education and training and are not in a position to earn an income that would lift them and their families above poverty levels. A program established in 1967, the Work Incentive Program, now gives many mothers currently on welfare, training and placement assistance so that they can improve their ability to support themselves and their dependents.

THE INCOME TAX

Devising a tax system which is equitable and efficient has always posed formidable problems, and often the best solution is one involving compromise with one or more of the objectives. The tax treatment of working wives is one of the more difficult problems. The income tax law as such treats men and women equally and, indeed, its effects on single men and single women are the same. However, some of the features of the tax structure, which have been considered desirable for other purposes, have, as a by-product, unequal effects on the second earner of a married couple, who is usually the wife.

Only income arising from market transactions is taxed. Indeed, there is no practical way to assign a market value to the unpaid work performed at home and then subject it to the tax. As a result, the tax system imposes a general bias in the economy favoring unpaid work at home compared to paid work in the market. However, the bias and the resulting disincentive toward market work are particularly relevant for the married woman who traditionally has done more work at home.

An equity problem also arises from this situation. To use a hypothetical example, a husband and wife each earning $8,000 would pay the same income tax as a couple where the husband alone works and earns $16,000, although the couple with two earners will have the additional expenses of buying the services which would be produced at home and untaxed if the wife did not work.

There is the further problem that a married couple may pay more or less income tax than two single persons whose combined income equals the couple's, depending upon how the income is divided between the two individuals. This problem reflects a basic ambivalence about whether the appropriate unit of taxation is the individual or the family.

Remedies for the situation are not easy to find. One suggestion has been to allow working wives to deduct a given percentage of their earnings from their income for tax purposes. However, this would be unfair to single persons, who also incur expenses of going to work. A general earned income credit has also been suggested, but this creates a bias against investments in capital and in favor of wage income.

As discussed below, the Revenue Act of 1971 has given expanded tax relief to working wives with children by allowing more liberalized child care deductions to couples within a given income range. This provision, however, does not affect couples without children or couples with combined incomes outside the allowable income range.

CHILD CARE

Provision for child care is a cost to working mothers and a major obstacle to the employment of many other mothers who would work outside the home if they could find satisfactory arrangements for taking care of their children. As more mothers have taken jobs outside the home, and more weigh the possibility of doing so, several major questions about child care have become intense national issues.

One question is whether the Government should pay for part or all of the cost of child care. This question is usually raised about the Federal Government, but it could be equally asked about State or local governments. According to one view of the matter parents have chosen to have children, which implies a certain allocation of their resources, therefore they have no reason to burden other taxpayers to look after the children. Another view of the matter is that Government subsidies can be justified and different groups have cited different reasons. The point has been made that the pressures of custom result in a bias against the wife going to work while the husband stays home with the children. A child-care subsidy for working mothers would help remove any harmful effects of this cultural bias. Another reason given is that there is a national interest in the proper care of children, who are, of course, the future nation, and that this case justifies Government subsidies. The analogy commonly given is to public education.

Government has given subsidies to families with children but there has been no consistent philosophy behind them. At the extreme, with respect to children in very poor families, we have long recognized the need for public assistance in the form of the program of Aid to Families with Dependent Children. This program is not specifically addressed to children with working mothers. In fact, until recently it was tilted *against* helping working mothers. The Federal Government also provides a form of assistance for child care through the income tax. With the Revenue Act of 1971, a much more liberal deduction than had ever been provided was instituted specifically for child-care expenses incurred by working wives. Below a combined husband-wife income of $18,000, a working wife can now deduct up to $400 a month for child care expenses. The deduction is scaled downwards to zero as combined income goes from $18,000 to $27,600. The two groups not covered are women whose family income is too low to benefit from a tax deduction and women at the other end of the income scale.

Public discussion of Government support for child care has not clearly distinguished among several possible objectives:

(a) To reward and assist the care of all small children;
(b) To assist the care of small children whose parents might not be otherwise able to care for them;
(c) To assist the care of the small children of working mothers;
(d) To assist in the care of small children in a particular way—through day-care institutions, or at home, etc.

Both the amount of Government support that is desirable, and the form it should take if it is to be provided, depend on the choice made among these objectives.

Recently, publicly supported institutional group care, or day care, has received considerable attention as one approach to helping the working mother. Some have also stressed day care as a developmental program. It may be noted that a very small proportion of working women have depended on group day care in an institutional center. A Government-sponsored survey of 1965 found that, among employed mothers of children under 6, only 6.4 percent depended on school or group care centers. About 47 percent of the women arranged to have their children cared for at home, often by a relative. The rest mainly arranged for care in someone else's home (31 percent) or looked after the child while working (15 percent).

Some have attributed the low use of day care to a failure of the market to provide a service that would be utilized if financing were available. Others have interpreted it as an indication that the true demand for institutional day care is low. Even among more affluent and knowledgeable working mothers who presumably could afford it, dependence on institutional group care is low. A survey of college graduates found that in 1964, among those who worked and who had children under 6 years, 9 percent used group care, which included nursery schools, kindergartens, and day-care centers. Most (73 percent) arranged for care in their own home.

Whether institutional day care provides the best use of dollars spent on child care has yet to be established. While this issue has not been resolved, it is clear that the problems of mothers who want and need to work require serious attention and a continuing search for new solutions.

GOVERNMENT ACTION

Government has been profoundly concerned with promoting full equality of opportunity for women within both the public and the private sectors. Two approaches have been followed. The first involves the use of law and regulations where they are both applicable and compatible with other goals of a democratic society.

A number of laws have been passed and Executive Orders issued which deal with discrimination by employers. Included are the Equal Pay Act of 1963, requiring employers to compensate men and women in the same establishment equally for work of equivalent skill and responsibility, and Title VII of the Civil Rights Act of 1964, which prohibits discrimination in hiring, discharging, compensation, and other aspects of employment. Title VII is administered by the Equal Employment Opportunity Commission (EEOC). The Equal Employment Opportunity Act, signed by the President in 1972, gave the EEOC enforcement power through the courts in sex-discrimination cases. In December 1971, Order No. 4, under Executive Order 11246, was extended to women. This Order requires Federal contractors employing more than 50 workers and holding contracts of $50,000 or more to formulate written affirmative action plans, with goals and timetables, to ensure equal opportunities. Title IX of the Education Amendments of 1972 prohibits discrimination in educational programs or activities on the basis of sex.

The Equal Rights Amendment to the Constitution, which was strongly supported by the President, passed the Senate on March 22, 1972, and has now been ratified by 22 States. The proposed amendment would provide that "equality of rights under the law shall not be denied or abridged by the United States or by any State on account of sex," and would authorize the Congress and the States to enforce the amendment by appropriate legislation. The purpose of the proposed amendment would be to provide constitutional protection against laws and official practices that treat men and women differently.

The other approach of Government to providing equality to women has been through leadership. The Women's Bureau in the Department of Labor has for 50 years been concerned with the problems of women at work. Recently, several new groups, each concerned with different areas affecting women, have been formed. The formation of the Advisory Committee on the Economic Role of Women is one such effort. The Citizen's Advisory Council on the Status of Women is another. The latter is a council of private citizens appointed by the President, which surveys the social and political issues of particular interest to women and makes recommendations for legislation or other suitable social action. In an effort to recruit women to top-level jobs in the Government, the President in 1971 appointed to the White House staff a special assistant for this purpose. As a result many women have been placed in key policy making positions, positions never before held by women.

It is only in the past few years that the problems women face as a group have been given the widespread recognition they deserve. There is much to be learned before we can even ask all the appropriate questions. Many of the problems involve profound issues of family and social organization. By listening to diverse groups and to the discussion of the public it is hoped that Government will be able to find its appropriate role. We believe that the newly formed Advisory Committee on the Economic Role of Women will contribute to that process.

CHAPTER 5

The International Economic System in Transition

THE INTERNATIONAL ECONOMIC POLICY of the United States had two major objectives in 1972. One was to improve the U.S. balance of payments, which had reached a record deficit of nearly $30 billion in 1971. The other was to make progress on reform of the international economic system, affecting monetary, trade, and investment relationships. The existing system has been unable to cope with shifting patterns of trade and imbalances in international payments which have resulted in repeated international economic and political tensions.

The groundwork for progress on both fronts had been laid in December of 1971 when the world's major industrialized countries met at the Smithsonian Institution. For the short term, the participants agreed on a realignment of exchange rates among the major currencies to relieve the existing disequilibrium in international payments. For the long term, they agreed to enter into multilateral negotiations on reform of the international economic system.

The overall balance-of-payments position of the United States, while still far from equilibrium, began to improve in 1972. The improvement, which was all in the capital account, was largely the result of a sharp reduction over 1971 in speculative outflows of capital. Domestic economic policies which curtailed the rate of inflation, the realignment of exchange rates, and renewed confidence in international monetary relationships all contributed to this improvement. The trade and current account deficits of the United States, however, were considerably larger in 1972 than in 1971, although they levelled off during the year. The year-over-year deterioration in these accounts stemmed primarily from the rapid growth of the U.S. economy and a lag in the economic recovery of some of the other major countries.

Progress was also made during 1972 on the longer-term reform objective. Agreement was reached on a format for international monetary negotiations. Discussions on the characteristics of a revised international monetary system are now underway, and the United States has set forth a number of proposals. The major industrialized countries have also agreed to initiate multilateral trade negotiations in the fall of 1973. Finally, these same countries have agreed to explore new forms of cooperation on internal policies which affect trade and investment among nations.

THE U.S. BALANCE OF PAYMENTS IN 1972

As this *Report* goes to press, official data for the U.S. balance of payments are available only for the first 3 quarters of 1972. These figures, shown in Table 29, indicate that, at annual rates, Americans imported $76.2 billion in goods and services during the first 9 months of 1972, while foreigners purchased $71.2 billion in U.S. goods and services. On balance, therefore, Americans obtained $4.9 billion more goods and services abroad than they provided to the rest of the world. In addition, U.S. Government grants and other types of unilateral transfers to foreigners exceeded similar transfers to the United States by $3.7 billion, and U.S. investments in long-term assets abroad exceeded foreign investments in U.S. long-term assets by $1.6 billion. Moreover, recorded short-term capital movements, nonrecorded transactions, and allocations of Special Drawing Rights (SDR's) together resulted in a net outflow of $1.4 billion. Overall, therefore, American balance-of-payments expenditures exceeded receipts by $11.6 billion. Virtually the whole deficit in the U.S. balance of payments on the official reserve transactions basis was financed by increased dollar holdings of foreign central banks.

TABLE 29.—*U.S. balance-of-payments transactions, 1971–72*

[Billions of dollars]

Type of transaction	1971			1972 first 3 quarters[1]		
	Receipts	Payments	Balance	Receipts	Payments	Balance
Goods[2]	42.8	45.5	−2.7	47.4	54.4	−7.0
Services	23.4	19.9	3.4	23.8	21.8	2.1
Military transactions	1.9	4.8	−2.9	1.2	4.7	−3.6
Investment income[3]	12.9	4.9	8.0	13.1	5.7	7.4
Other	8.5	10.2	−1.7	9.6	11.3	−1.8
GOODS AND SERVICES	66.1	65.4	.7	71.2	76.2	−4.9
Unilateral transfers, net[4]		3.6	−3.6		3.7	−3.7
CURRENT ACCOUNT	66.1	69.0	−2.8	71.2	79.9	−8.7
Long-term capital	1.8	8.2	−6.5	5.1	6.7	−1.6
U.S. Government[5]	−.5	1.9	−2.4	.3	1.3	−1.0
Direct investment	−.1	4.8	−4.8	.3	3.3	−3.0
Other private	2.3	1.6	.8	4.4	2.1	2.4
CURRENT ACCOUNT AND LONG-TERM CAPITAL	67.9	77.2	−9.3	76.3	86.6	−10.2
Short-term nonliquid capital	(6)	2.4	−2.4	.1	.7	−.6
Short-term liquid capital	−6.7	1.1	−7.8	2.9	1.4	1.5
Errors and unrecorded transactions, net		11.0	−11.0		3.0	−3.0
Allocations of SDR's	.7		.7	.7		.7
TOTAL	61.9	91.7	[7] −29.8	80.0	91.7	[7] −11.6

[1] Seasonally adjusted annual rates.
[2] Excludes transfers under military grants.
[3] Includes direct investment fees and royalties.
[4] Excludes military grants of goods and services.
[5] Excludes official reserve transactions and includes transactions in some short-term U.S. Government assets.
[6] Less than $0.05 billion.
[7] Equals official reserve transactions balance.

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce.

THE GOODS-AND-SERVICES ACCOUNT IN 1972

For the goods-and-services account, preliminary estimates are available for the full year 1972. These figures differ slightly from those in Table 29, which are annual rates based on data for the first 3 quarters. These preliminary estimates indicate that the United States imported about $4½ billion more goods and services than it exported. U.S. imports of goods exceeded exports by about $7 billion in 1972, while exports of services exceeded imports by about $2½ billion. These figures represent a substantial deterioration in the goods-and-services account from the full year 1971.

On a quarterly basis, net imports increased from $1.2 billion in the first quarter of 1972 to $1.6 billion in the second quarter and then declined to $900 million in the third quarter and remained at about the same level in the fourth. When exports and imports are calculated in volume terms by adjusting for price changes, the quarterly decline in net imports begins somewhat sooner (in the first quarter rather than the second) and is more marked over the course of the year.

The figures just cited give early indications that the dollar devaluation, reinforced by a lower rate of inflation in the United States than in other major industrialized countries in 1972, is beginning to affect U.S. exports and imports. The fact remains, however, that the U.S. trade deficit was much larger in 1972 than had been expected after the realignment of exchange rates. Cyclical developments in the United States and abroad were a major reason for this disappointment. Nominal gross national product (GNP) in the United States grew by nearly 10 percent in 1972, compared to 7½ percent in 1971 and 5 percent in 1970. Thus while changes in relative prices reduced the attractiveness of foreign goods compared to domestic goods, the level of imports continued to increase with the rapid rise in the overall demand for goods in the U.S. economy. At the same time, a number of major industrial countries experienced lower than normal rates of growth in 1972, which tended to hold down the increase in their demand for U.S. goods.

Apart from the effects of these cyclical developments, the response to any devaluation is generally delayed. First, it takes some time before a devaluation is reflected in the relative prices obtained by exporters and paid by importers. In the short run, to protect their market shares, foreign exporters frequently do not increase their list price in the U.S. market by the full amount of devaluation. Conversely, foreign importers frequently do not reduce their list price of U.S. goods in the foreign market by the full amount of the devaluation.

Second, when the change in relative prices does occur, its initial impact is likely to be perverse because a devaluation raises the dollar prices of imported goods and services before the volume of exports and imports responds to the changes in relative prices. In time, the effect of devaluation on real trade flows is expected to outweigh the change in prices. It is because of this sequence of events that one expects the trade balance of a devaluing country to improve in real or volume terms before it improves in value terms, which is what happened in 1972.

In the case of the United States, the trade deficit in 1972 was also affected by long-run changes in the demand for basic materials. In particular, domestic production of fuels has not kept pace with the growth of the U.S. economy, and consequently net imports of fuels increased from $1.7 billion in the first 10 months of 1971 to $2.6 billion in the first 10 months of 1972. Although U.S. exports of agricultural products have also expanded rapidly, they have not fully offset this increased demand for fuels. On balance, long-term changes in trade patterns have tended to make the elimination of the U.S. balance-of-payments deficit more difficult.

THE CAPITAL ACCOUNT IN 1972

Returning to the balance-of-payments figures in Table 29, the net outflow of capital from the United States fell from $27.7 billion in 1971 to an annual rate of $3.7 billion in the first 3 quarters of 1972. This sharp reduction was due to several factors.

First, the realignment of exchange rates, and the preservation of international monetary cooperation among the major countries, reestablished confidence in international monetary relationships. Investors had less incentive to hedge against the risk of a change in exchange rates or the imposition of new restraints on capital transfers, and some investors were induced to bring back funds transferred abroad in 1971 for hedging purposes.

Second, a tightening of credit conditions in the United States relative to some major European countries led to a reversal in the flow of interest-sensitive funds. In line with this trend, foreign banks placed liquid funds in the U.S. money market.

Third, the rapid expansion of the U.S. economy created improved investment opportunities in the United States, and sluggish rates of growth in a number of major foreign countries reduced incentives for U.S. investment in these countries. In particular, the improved economic prospects in the United States made purchases of U.S. stocks more attractive to foreigners.

These factors affected both short-term capital movements, which recorded a net inflow of $0.9 billion at an annual rate in the first 3 quarters of 1972 compared to a net outflow of $10.2 billion in 1971, and long-term capital flows, which recorded net outflows of $1.6 billion at an annual rate in the first 3 quarters of 1972 compared to $6.5 billion in 1971.

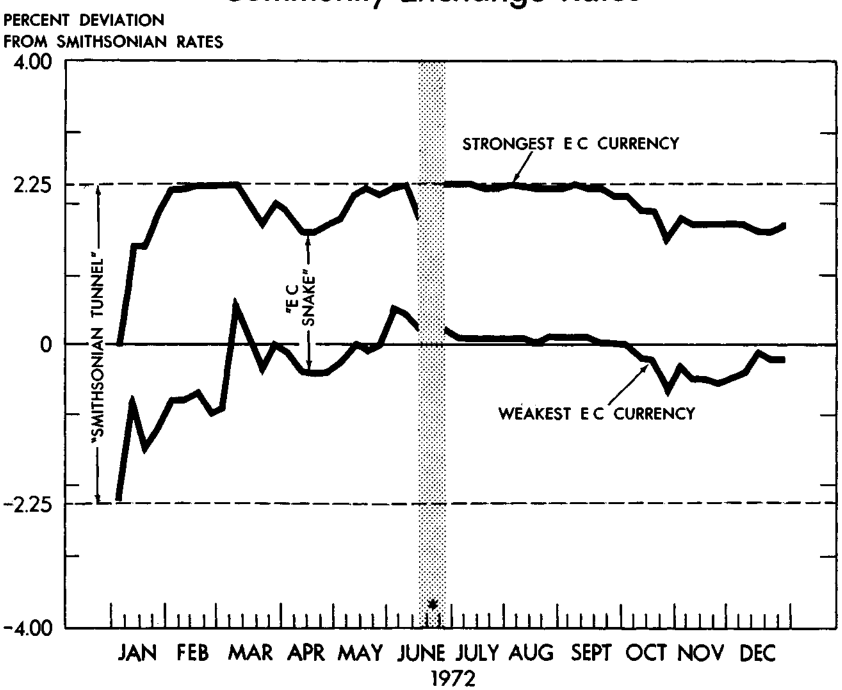
FOREIGN EXCHANGE MARKET DEVELOPMENTS IN 1972

When the supply of a currency exceeds the demand its value tends to drop in foreign exchange markets, and when the demand exceeds the supply its value rises. In order to hold currency values in the foreign exchange market within certain limits, governments other than the United States have followed the practice of entering the market as buyers or sellers of their own currency whenever its value in terms of U.S. dollars falls or rises beyond a certain range. On the basis of the Smithsonian Agreement that range was established as a maximum deviation of plus or minus $2\frac{1}{4}$ percent from the announced parity or central rate of that currency vis-a-vis the dollar; a total of $4\frac{1}{2}$ percent.

Movements in the exchange rate between the dollar and the major foreign currencies can be seen in Table 30. Chart 11 shows the movements of the currencies of the European Community (EC). The EC countries have agreed to keep their currencies within a maximum range of $2\frac{1}{4}$ percent of each other, which is half the maximum spread allowed between any two currencies other than the dollar by the Smithsonian Agreement. This narrowed intra-European band of fluctuation is generally known as the "EC snake in the Smithsonian tunnel."

Chart 11

Movement of European Community Exchange Rates



*STERLING CRISIS.
NOTE: DATA RELATE TO FRIDAY RATES IN THE EXCHANGE MARKETS OF COUNTRIES BELONGING TO THE EUROPEAN ECONOMIC COMMUNITY (EC).
SOURCE: TREASURY DEPARTMENT.

Table 30.—*Percent deviations of major foreign currencies from central rates, December 1971–December 1972*

[Currency units per U.S. dollar [1]]

Currency	Central rate	Deviation of currency at end of period from central rate						
		December 1971	1972					
			February	April	June	August	October	December
British pound	2.60571	−2.1	0.0	0.2	−6.2	−6.0	−10.5	−10.0
Belgian franc	44.8159	.4	2.2	1.5	2.2	2.0	1.6	1.7
Swiss franc	3.84	−2.0	−.8	−.6	2.5	1.6	1.1	1.9
West German mark	3.2225	−1.5	1.1	1.3	2.0	1.0	.6	.7
French franc	5.1157	−2.1	.9	1.6	2.2	2.2	1.6	−.1
Italian lira	581.5	−2.1	−.9	−.4	.2	.1	−.6	−.2
Netherlands guilder	3.2447	−.3	2.1	.8	2.2	.5	.5	.6
Canadian dollar [2]		([3])	−.2	.9	1.7	1.8	1.8	.5
Japanese yen	308.0	−2.2	1.2	1.0	2.2	2.2	2.2	2.2

[1] British pound and Canadian dollar are expressed in U.S. dollars per unit of currency. Percent deviations are based on mid-day selling rates in London.
[2] Measured by deviation from 1-to-1 relationship between U.S. dollar and Canadian dollar.
[3] Less than 0.05.

Source: Treasury Department.

Changes in reserves of the major countries, as well as changes in U.S. liabilities to all foreign central banks, are shown in Table 31. Changes in reserve holdings of foreign central banks reflect primarily their intervention in the foreign exchange market to keep the value of their currencies within the agreed margins. Changes in U.S. liabilities to foreign central banks show the extent to which foreign central banks have acquired claims against the United States as a result of intervention in the foreign exchange market.

Table 31.—*Changes in official reserves for selected countries and changes in U.S. liabilities to foreign official reserve holders, 1972*

Country	1972 change (billions of dollars) [1]			
	Total [2]	First quarter [3]	Second quarter [4]	Third quarter
Total official reserve for countries below	8.5	4.1	0.4	3.9
Belgium	.6	.2	.2	.2
Canada	.5	.2	.3	([5])
France	1.8	.2	.9	.6
Italy	−.4	−.1	−.2	([5])
Japan	1.1	1.3	−.8	.6
Netherlands	1.1	.6	([5])	.5
Sweden	.3	.2	.1	([5])
Switzerland	.4	−.2	.3	.4
United Kingdom	−2.7	.4	3.2	([5])
West Germany	5.8	1.4	2.9	1.5
U.S. liabilities to foreign official reserve holders	9.4	3.2	.8	5.4

[1] Quarterly changes are based on data for end of quarters.
[2] Total change for first 3 quarters.
[3] Total official reserves in the first quarter include 1972 SDR allocations of $1.2 billion.
[4] Second quarter data have been adjusted to reflect sterling outflows which were not recorded until the third quarter.
[5] Less than $0.05 billion.

Note.—Detail may not add to totals because of rounding.

Source: International Monetary Fund.

The dollar was under downward pressure and, conversely, most other currencies were under upward pressure, at the beginning of the year, before the Smithsonian rates had become fully established, and during the summer, when a loss of confidence in the established value of the pound sterling raised questions about the whole Smithsonian structure of exchange rates. During the spring and the latter part of the year, the dollar strengthened relative to most other currencies. These movements in the value of the dollar reflected primarily changes in the degree of confidence in existing exchange rates. Changes in credit market conditions in the United States relative to those abroad also played a role.

Two major currencies did not follow the general pattern described above, the British pound and the Japanese yen. The pound sterling came under considerable downward pressure toward the end of June, when a number of factors created considerable doubt regarding the long-term viability of the British exchange rate established at the Smithsonian. After losing a considerable amount of foreign exchange in preventing the pound from dropping below the Smithsonian floor, the British authorities allowed the pound to float downward in response to market pressures. Over the next 6 months the pound dropped 10 percent below the rate set at the Smithsonian.

The Japanese yen has been under upward pressure since the end of June, reflecting the sizable surplus in the Japanese balance of payments. Throughout the second half of the year, the Japanese authorities were required to purchase large amounts of dollars in the foreign exchange market to keep the value of the yen from rising above the Smithsonian ceiling. During this period, forward yen rates remained substantially above the Smithsonian ceiling, reflecting market uncertainty over the existing yen parity.

The renewed confidence in existing exchange rates in the latter part of 1972, with the two exceptions just described, had several causes. One was that the determination of governments to support the Smithsonian rates was reaffirmed in July by a number of major governments. U.S. intervention in the exchange markets on a limited basis, and the stated willingness of the United States to take such action when it was desirable as a means of dealing with speculative pressures, were important symbols of cooperative support for the Smithsonian Agreement. The fact that the U.S. price performance in 1972 was better than that of any of its major partner countries, despite our rapid expansion, also contributed to the improvement in confidence during the second half of the year.

REFORMING THE INTERNATIONAL ECONOMIC SYSTEM

Changes are required in monetary arrangements, in trading arrangements and in procedures for dealing with policies usually considered to be "domestic" but having a significant impact on international transactions. The United States has strongly emphasized not only that reform is needed in all three of these areas but also that the reforms in all three must be considered as part of a single package, since policies adopted in one field may complement or conflict with policies in the others. However, thinking is now farthest advanced with respect to monetary reform and we devote most of this chapter to it.

The President has also taken steps to improve the handling of international economic issues within the U.S. Government, to take better account of the close interconnections of all aspects of international economic policy with each other and with domestic policy. The recently created Council on Economic Policy will provide a framework for the unified consideration of domestic and international economic issues. The Council on International Economic Policy (CIEP) continues to have responsibilities for foreign economic policy within the framework of the Council on Economic Policy, and the director of CIEP is a member of the latter group. Other steps to improve the handling of the economic aspects of foreign relations include the appointment of a higher ranking official to be responsible for economic policy in the State Department and the development of more effective procedures for the National Advisory Council on International Monetary and Financial Policies, the body which coordinates the foreign lending policies and activities of the U.S. Government.

THE INTERNATIONAL MONETARY SYSTEM

The suspension of the convertibility of the dollar into gold on August 15, 1971, gave public recognition to the fact that the postwar international monetary arrangements, known as the Bretton Woods system, had become untenable. Interim arrangements, including the negotiation of a multilateral realignment of exchange rates at the Smithsonian Institution in December 1971, have been developed, but they do not provide a long-term solution to the problems which made changes in the rules of the Bretton Woods system inevitable. The arrangements have greatly facilitated the maintenance of normal international commercial and investment relationships, but they do not constitute an adequate system of rules for the international monetary system in the long run.

A stable international monetary system must meet several major requirements if it is to serve as the basis for the continued expansion of world trade and investment. First, it should be *market-oriented*. For the sake of both efficiency and equity, the mechanism for balancing each country's total foreign exchange receipts and payments over the long run should function in such a way as to minimize interference with individual market transactions. Second, the settlement of payments balances among countries should be *multilateral*, so that every country can offset its deficits with some countries by means of surpluses with others. To fulfill this condition, the system must provide for the ultimate settlement of claims in terms of commonly accepted reserve assets. Such a generalized payments system makes possible a far higher level of international trade and investment transactions than would be feasible if each country had to balance its payments bilaterally with every other country in a network of barter relationships. Third, the system should be *stable.* International commerce frequently entails long-run commitments and hence requires stable expectations about conditions affecting the future profitability of international transactions.

In order to meet these requirements the international monetary system must fulfill certain specific functions. It must provide an effective and equitable mechanism for *adjustment* of payments imbalances among countries, so that external payments imbalances are not allowed to persist and accumulate. It must also provide international monetary reserves in adequate amounts and in forms acceptable to the participants in the system, i.e., international *liquidity* has to be adequate. If the system permits the creation of too much international money, international inflationary pressures will be created; if too little international money is created, deflationary pressure or pressures for restrictions on international transactions will result. Finally, the system must operate in such a way as to create and maintain *confidence* in its continued viability and in the value of the international reserve assets associated with it.

Characteristics of the Bretton Woods System

The Articles of Agreement which established the International Monetary Fund (IMF) in the immediate postwar period reflected a heavy emphasis on the need for stability and confidence in the international monetary system. The rules embodied in the Articles dealt primarily with such questions as the conditions under which governments could change their exchange rates, or borrow from the Fund to cover deficits, or impose exchange restrictions. The primary objective was to prevent arbitrary actions by governments in these areas, and in meeting this objective the Articles were highly successful.

Under the Articles of Agreement, governments were obligated to support their exchange rates at agreed parity levels in either of two ways—by buying or selling their own currency in the foreign exchange market whenever the rate rose 1 percent above or fell 1 percent below parity, or by making their currency convertible into gold or other reserve assets at the request of a foreign official institution. In practice, all countries but the United States have supported their currencies by buying or selling them for dollars, while the United States has maintained the convertibility of dollars into gold or other reserve assets tied to gold.

The rules permitted changes in a country's parity when its balance of payments was in fundamental disequilibrium. In practice the parities were changed only infrequently, generally after a prolonged period of disequilibrium in external payments. There was also a widespread belief that, because of the importance of the United States in world trade and the central role of the dollar in the international monetary system, the United States could not change its exchange rate. In any case, since most other countries were pegging their rates to the dollar in the foreign exchange market, the United States could not be certain that a change in the price of gold would actually result in a change in the value of the dollar in terms of foreign currencies.

The Articles of Agreement did not address themselves explicitly to the question of liquidity. The expectation was that, as in the past, newly mined gold would provide the major source of new official reserves. It was also implicitly assumed that countries would hold certain currencies as additional reserves. There were no arrangements, however, for reviewing or influencing the growth of liquidity. The growth of reserves was thus dependent on the vagaries of gold markets and on deficits in the balance of payments of reserve currency countries. In practice, the U.S. deficits provided the bulk of new reserves for the rest of the world.

The inadequacies of the system with respect to the process of liquidity creation led to an important step forward with the recent creation of Special Drawing Rights (SDR's), an internationally created obligation of the International Monetary Fund. With the establishment of SDR's, the system no longer had to rely on a persistent deficit in the U.S. balance of payments for the creation of new reserves. The creation of SDR's could not in itself restore equilibrium to international payments, however, since provisions for the adjustment of payments imbalances remained inadequate.

The Articles of Agreement were not very explicit about the circumstances under which countries should take action to remove balance-of-payments deficits or surpluses. The assumption was that deficit countries would sooner or later run out of reserves or borrowing facilities and therefore would have to adjust. However, surplus countries could postpone adjustment as long as they were willing to accumulate reserves. Since the major deficit country, the United States, could not adjust its exchange rate without endangering the operation of the system, and since most of the surplus countries were persistently reluctant to change their own rates, the disequilibrium in world payments increased through the latter half of the 1960's until it reached a breaking point in mid-1971. At that time, the disequilibrium became so large that speculative pressures caused billions of dollars to be exchanged for foreign currencies within a few days. These currency movements greatly increased U.S. liabilities to foreign official institutions and further reduced the stock of U.S. reserve assets. This brought to a head a problem which had been developing for some time: how to maintain convertibility as the stock of dollars held by foreign official institutions grew and the United States' own stock of reserve assets, mainly gold, shrank.

On August 15, the President announced a suspension of the convertibility of the dollar into gold or SDR's. This action withdrew U.S. support from the old exchange rates between the dollar and other foreign currencies, and in effect put the dollar on a floating basis. Subsequently, a new set of exchange rates was agreed upon at the Smithsonian Institution, and as part of that realignment the United States agreed to increase the U.S. official price of gold from $35 to $38 an ounce. This 8.5-percent increase in the price of gold was signed into law on March 31, 1972. The United States has not resumed the convertibility of the dollar, but has said that it will undertake appropriate convertibility obligations in the context of a suitably reformed international monetary system, provided that the U.S. balance-of-payments and reserve positions improve sufficiently to make such an undertaking viable.

Preparations for International Monetary Reform

Some of the major problems to be dealt with in a reform of the international monetary system, as well as a number of approaches to their solution, were examined in a report submitted by the Executive Directors of the International Monetary Fund to the Board of Governors in August 1972. At about the same time, the member countries of the International Monetary Fund agreed to create a committee to conduct negotiations on reform. This committee, the Committee of Twenty, is patterned after the representational system used in the Executive Board of the International Monetary Fund, where the membership is broken down into twenty constituencies, each with a single spokesman to act on behalf of all the countries in the constituency. Although some of the constituencies are formed by single large countries, as is true with the United States, most comprise several smaller countries. The first meeting of this new group was held at the annual session of the International Monetary Fund in September 1972; this was followed by several meetings of deputies, who expect to prepare a draft outline of the main reform proposals in time for the 1973 annual meeting of the International Monetary Fund.

U.S. Ideas on International Monetary Reform

In order to help get the negotiation process underway, the United States has advanced some general proposals on reform. The U.S. approach is evolutionary, seeking to build on existing principles and practices where they have proved useful and have met with international approval. At the same time, it proposes certain important changes to ensure the viability of the new system. The primary emphasis is on the creation of an effective and evenhanded mechanism for the adjustment of payments imbalances that would place all countries, surplus and deficit alike, under agreed and broadly symmetrical rules and responsibilities for taking action to restore equilibrium. In the U.S. view, the most promising approach is a system in which disproportionate changes in a nation's reserves in either direction indicate the need for measures to eliminate the payments imbalance. Within such a system of symmetrical adjustment discipline, the U.S. approach would allow considerable diversity in the choice of instruments for bringing about adjustment. One way to widen the choice of adjustment tools would be to allow increased flexibility of exchange rates.

With respect to international liquidity, the U.S. proposal envisages an increase in the importance of the SDR and the elimination of various encumbrances which reduce its usefulness as a reserve asset. At the same time, the U.S. proposal contemplates a gradual diminution of the role played by gold in the international monetary system. Holdings of foreign currency reserves would be neither banned nor encouraged, but it is expected that they would become a smaller proportion of total international reserve assets than they are today.

The Adjustment Process

In developing its proposals the United States has taken into account a number of realities about the international adjustment process. First, every government seeks to retain a large degree of discretion in managing its economy, in order to meet the specific social and economic concerns of its citizens. Second, the policies of every government are necessarily affected and constrained by the interaction of its economy with the outside world, since international trade and investment are increasingly important factors in the economic prosperity of all countries. The U.S. proposal seeks to achieve a proper balance between these two conditions by retaining considerable national discretion with respect to the method and timing of adjustment, but by imposing a stronger international discipline to ensure the achievement of adjustment objectives.

Reserves as objective indicators for adjustment. The U.S. proposal, that disproportionate changes in reserves in either direction be used as the primary indicator of the need for balance-of-payments adjustment, is described in detail in Appendix A. In summary, the proposal is that certain points should be established above and below each country's "base," or "normal" level of reserves, and that movements in reserves beyond these points would signal the need for balance-of-payments adjustment.

The U.S. proposal is based on the recognition that countries experiencing a persistent deterioration in their reserve positions have always had to devalue their currencies or to take other adjustment measures. The U.S. proposal would make this discipline symmetrical for both deficit and surplus countries by providing that a disproportionate gain in reserves would indicate the need for adjustment actions by surplus countries to the same extent that disproportionate reserve losses now impose pressure on deficit countries to adjust.

Symmetry in the adjustment process, as provided for in the U.S. proposal, is desirable for several reasons. Active implementation of adjustment policies, as opposed to passive acceptance of the domestic consequences of adjustment by others, frequently entails political costs (as in the case of an exchange rate change, which governments have commonly considered to be a confession of weakness). And it may sometimes involve economic costs of adjustment as well (when, for example, a deficit country tolerates an increase in unemployment in order to improve the payments balance through demand restraint). Thus, a balanced distribution of the responsibility for initiating adjustment is in part a question of equity.

Such symmetry also makes the process of international adjustment more efficient. If countries on both the deficit and the surplus sides of a payments imbalance follow active policies for the restoration of equilibrium the process is likely to be easier than if the deficit countries try to bring about adjustment by themselves. Deficit countries would in any case be unable to restore equilibrium unless surplus countries at least followed policies consistent with a reduction of the net surplus in their payments positions. Such problems can best be avoided by clarifying the responsibilities of both groups of countries in bringing about payments adjustment.

The use of reserve criteria also focuses on the close relationship between the speed of adjustment and the need for liquidity. The less efficient and prompt the adjustment process, the larger is the global need for reserves; the smaller and less elastic the total stock of reserves, the more stringent the demands will be on the adjustment process. In a system where the adjustment process is tied to reserves, the total volume of reserves created can be related to the sum of countries' individual reserve targets as reflected in the internationally agreed indicators. If the two are not made consistent, sustained balance-of-payments equilibrium cannot be obtained. Failure to provide the system with adequate reserves puts deflationary pressure on deficit countries and induces a disruptive competition for scarce reserves. In contrast, the creation of too large a volume of reserves places the major share of adjustment pressures on surplus countries and exacerbates tendencies toward world inflation.

A link between adjustment measures and reserve changes is essential if a generalized system of convertibility of national currencies into international reserve assets is to be sustainable. In the long run, convertibility can be maintained only if the adjustment mechanism prevents the development of large and persistent imbalances which would inevitably prevent a deficit country from providing conversion of its own currency into primary reserve assets.

Reserve indicators have several other advantages as compared to other conceivable adjustment guides. They are comprehensive, quickly available, and relatively unambiguous. Furthermore, they do not discriminate between one set of transactions and another. They leave the relation between specific types of transactions to market forces, focusing only on the overall level of the balance of payments. In a system based on the market principle, it would be inappropriate to base judgments about the need for adjustment solely on trade, or the current account, or the capital account.

Adoption of reserve criteria as a primary indicator of the need for adjustment does not imply automaticity. The system would operate in the context of a multilateral review procedure. While excessive reserve changes may create an increasingly strong presumption that effective adjustment measures are called for, a country could still convince the international community that the signals were wrong and adjustment was not appropriate. In such a case the reserve indicator could be overriden. Moreover, the use of reserve indicators would not preclude such supplementary guides as might be available.

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Short-term capital movements may present a problem in managing any system of adjustment, including one based on reserve indicators. Large movements of such funds in response to differences in interest rates, or the expectation of future changes in exchange rates, could bring about large changes in reserves. This could signal the need for adjustment actions even though they might not otherwise be thought appropriate. It should be possible, however, to identify such cases in the multilateral review and to override the signal by international agreement. Moreover, the wider margins within which exchange rates can fluctuate have already provided a useful cushion against short-term capital movements initiated by interest rate differentials, and these margins should become more effective in a system where the maintenance of inappropriate parities is avoided.

Greater flexibility in the exchange rate. An important feature of the U.S. proposals is that they would make exchange rate changes a more useful internationally acceptable instrument of adjustment. The U.S. suggestions regarding the exchange rate mechanism assume that most countries will generally choose to continue their practice of maintaining established values for their currencies. At the same time, the United States recognizes that the difficulties caused by prolonged maintenance of inappropriate exchange rates can be avoided only if countries adjust their parities more promptly than was usual in the past.

The U.S. proposal recognizes the current evolution of more flexible techniques of exchange rate management. For example, despite the fact that floating a currency—suspending the maintenance of its value by exchange market intervention—is technically a violation of the Bretton Woods Agreement, a number of important countries have done so. Such floats may be either transitional, as a way of utilizing market signals in determining a new rate, or indefinite in their duration. The Canadians have floated during long intervals for more than two decades, the Germans have floated twice in recent years, and the British have been floating since mid-1972. The U.S. proposal would permit either transitional or indefinite periods of floating, but it would impose standards on countries adopting floating regimes to guard against their use as instruments for competitive devaluation.

The United States also proposes that countries which maintain parity exchange rates adopt wider margins within which the market exchange rate is allowed to fluctuate. The Smithsonian Agreement temporarily increased the permissible margins from 1 percent on either side of dollar parity to 2¼ percent above or below dollar parity, implying a maximum spread of 4½ percent between any two nondollar currencies. A number of countries have adopted these wider margins. The United States favors the permanent adoption of margins for all currencies, including the dollar, that are in the same range as those permitted for nondollar currencies under the Smithsonian Agreement. Since the dollar currently serves as the chief intervention currency it can never deviate from its parity with any other currency by more than the width of the margin, or 2¼ percent. For any two nondollar currencies, however, the maximum spread is twice the margin, because one currency could be at the floor while the other currency was at the ceiling. To do away with this particular asymmetry will require innovations in the techniques of exchange market intervention, a question which will have to be addressed in the context of the general reform effort.

A larger zone within which fluctuation can take place without government intervention implies more opportunity for the operation of market forces and can facilitate small changes in parities. Wider margins can also lessen the incentives for short-term capital flows in response to interest rate differentials by increasing the scope for forward premiums or discounts in the exchange markets, thus neutralizing such differentials.

The desire for symmetry between the margins for the dollar and for other currencies reflects the view that, whereas the dollar had unique functions and responsibilities in the old system, its role in the new system should be closer to that of other important currencies. Under the Bretton Woods system, other countries maintained or changed the values of their currencies in relation to the dollar, and the United States was passive. The proposed change would give the United States more freedom to exercise control over its own exchange rate, not only in influencing the rate within the margins around parity, but also in changing the parity itself. Of course, under any system this freedom will be limited by the fact that the United States is so important in world trade that any change in the value of the dollar would strongly affect other countries. In addition, the dollar will undoubtedly continue to be an international medium of exchange, even when no Americans are involved, and substantial amounts of dollars will still be held abroad in private and official hands. Therefore, reasonable stability in the value of the dollar will be desirable. Nonetheless, in a reformed system the dollar should have considerably more flexibility than it did before.

Other techniques of adjustment. Under the U.S. proposal a variety of mechanisms for restoring payments balance would be available, among them changes in monetary and fiscal policy. Furthermore, in keeping with the goal of the international monetary system to encourage a freer flow of resources, surplus countries would be encouraged to remove barriers to imports and capital outflows, while deficit countries would be encouraged to remove barriers to exports and capital inflows.

Such a choice among adjustment measures is essential, not only to preserve national sovereignty, but also because the nature of the imbalance may itself suggest a particular form of policy response. Furthermore, the existence of uncertainty about whether or not adjustment will take the form of a change in the exchange rate can itself be a stabilizing influence by holding down speculation in response to reserve changes.

The U.S. proposal would in extreme circumstances permit the imposition of direct restraints for balance-of-payments purposes. Their use, however, would be appropriately circumscribed to ensure that controls remained temporary and caused the least possible distortion in the pattern of trade and investment. Controls or surcharges on some transactions and not on others distort economic relationships, and for that reason broad adjustment measures are generally preferable. And where selective measures are used, price-based barriers such as taxes or surcharges are generally preferable to quantitative barriers such as quotas. Taxes on some transactions and not on others change relative prices, but they do not insulate such transactions from market pressures, as quotas do. This view contrasts with the present rules of the General Agreement on Tariffs and Trade (GATT), which specifically authorize quantitative restrictions but not surcharges for balance-of-payments purposes.

The U.S. proposal furthermore reflects the view that controls on capital transactions for balance-of-payments purposes should not be encouraged and certainly should not be required in lieu of other measures of adjustment, nor should they become the means of maintaining an undervalued or overvalued exchange rate. This position is based on a belief that restrictions have a distorting influence whether they are focused on trade in commodities, in services, or in assets (the capital account), and that this parallelism should be recognized in the rules governing the reformed international monetary system. In contrast, the provisions of the earlier system made a sharp distinction between controls on trade and other current transactions and controls on capital transactions.

The U.S. proposal assumes that countries would take their responsibilities seriously and would usually take steps toward adjustment before such steps became necessary on the basis of the indicators. In the few cases where countries might persist in avoiding adjustment, however, certain international sanctions would become operative. On the deficit side, for example, failure to adjust might lead to refusal to provide credit, as under the old system, or to loss of scheduled SDR allocations. On the surplus side, the international inducements for adjustment might include the risk of losing scheduled SDR allocations or a tax on the country's excess reserve holdings. In some situations, other countries might be authorized to impose a surcharge on imports from the chronic surplus country until effetive measures were taken to correct the situation. The Bretton Woods Agreement incorporated a provision similar to this last one, the so-called scarce currency clause. However, because this provision was never invoked, there was no effective form of international pressure on surplus countries to adjust.

International Liquidity

The magnitude, composition, and distribution of world liquidity have undergone substantial changes in recent years. From the end of 1969 to the end of October 1972, gross international official reserves increased from $78 billion to $152 billion, or almost 100 percent in 3 years. Part of this increase was in newly created Special Drawing Rights, but most of it was in dollars. Gold and reserve positions in the International Monetary Fund remained at approximately the same level as in 1969. As a result, a significant change occurred in the proportional composition of international reserves. Gold dropped from 50 percent to 26 percent, reserve positions in the IMF dropped from 9 percent to 4 percent, foreign exchange rose from 41 percent to 64 percent, and SDR's, which did not exist in 1969, provided 6 percent of world reserves.

For the future, the United States supports movement toward increasing reliance on the SDR as the primary source of world reserve growth and toward progressive reduction in the role of gold as a reserve asset. The U.S. proposal also assumes that currencies will play a much smaller role in reserve holdings in the future than they do today. In that connection, proposals for exchanging a portion of reserve currency holdings into a special issue of SDR's deserve careful study as part of the transition to a new system.

SDR's as the primary international reserve asset. As part of its proposals for reform, the United States has supported increased importance for SDR's; they should become the formal unit of account of the system, to serve as the common reference point for currency rates and as a common measure of the value of reserve assets. Such an arrangement would offer important advantages, in that it would eliminate several potential sources of instability—private and official—which have been particularly troubling for the international monetary system in the past.

First, the system would not be subjected to strains arising from private demands for the primary reserve asset. The SDR has no commodity uses and there are no plans, at least at the present time, for allowing the SDR to be held as a financial asset in private hands. The value of the SDR in terms of currencies would be determined purely on the basis of considerations related to the monetary system itself, and not by occurrences in often volatile commodity markets.

Second, the system would not have to depend on increasing the value of the SDR for increases in official liquidity. Instead, the SDR was designed to expand (or contract) international liquidity through changes in the volume of SDR units outstanding, thus avoiding speculative problems caused by changes in the value of the basic reserve asset relative to other types of money.

Third, SDR's would not be subject to the problem of confidence created by primary reliance on reserve currencies. Under the Bretton Woods system, the demand for reserve assets was increasingly met by the reserve currencies. The larger the amount of a currency held by foreign official institutions, however, the greater the risk that confidence may be undermined by the accompanying deficit in the balance of payments of the issuing country. Furthermore, the commitment of the reserve currency country to maintain convertibility into reserve assets becomes less and less credible as the stock of its outstanding liquid liabilities increases. The SDR is not subject to these particular problems of confidence, since the liability is spread among all participating countries and it is not convertible into other reserve assets. Confidence in the SDR is primarily a function of the commitment and willingness of governments to accept it in settlement of debts.

Certain changes in the nature and the use of the SDR would make it a more attractive and useful asset. To the extent possible, for instance, SDR's should be freed from the encumbrances of reconstitution obligations, designation procedures, and holding limits. These special features of the SDR mechanism were probably necessary when that instrument was a new and untested asset. In the absence of an effective adjustment mechanism, it was considered desirable to place limitations on the magnitude of payments imbalances to be financed through SDR transfers. The need for such special features would be reduced or eliminated in a reformed system. Moreover, the elimination of these special provisions would enhance the SDR's practical utility. The rules of the International Monetary Fund should also be changed to permit SDR's to be used in all IMF transactions now permitting or requiring gold. SDR's would thus truly become the basic international money.

The role of reserve currencies. The United States has also proposed that in a reformed system official holdings of foreign exchange should be neither banned nor encouraged. Such holdings of national currencies may provide a useful margin in reserve management, and fluctuations in such holdings could add some elasticity to the system as a whole in meeting sudden flows of volatile capital. A system which prohibited nations from holding foreign exchange other than working balances would be a much more rigid system. It would provide no short-term flexibility to allow for reserve expansion over and above SDR allocations when the demand for reserves is abnormally high for brief periods and there are no other immediately available means for responding to sudden and reversible speculative pressures. In practice, there would be a much greater danger that such a rigid system would break down under the normal pressures which can develop in a liberal world trading and payments order where the level of international transactions is large in comparison with the level of world reserves. Inability of the international reserve mechanism to adapt flexibly in periods of strain could seriously undermine the effort to move toward a more liberal trade and payments system. At the same time, since countries would commit themselves to convert foreign official currency holdings into common reserve assets, a country should be able to place limits on the amount of its currency which other countries may hold as reserves.

Gold as reserves. The United States believes that the role of gold in the international monetary system should continue to diminish, and would support orderly procedures to facilitate that process. A declining role for gold is fully consistent with the long-term trend of monetary history. Governments long ago recognized the inadequacy of gold as a basis for national monetary systems, and in recent decades the dependence of the international economy on that metal has diminished sharply. With the physical supply of gold limited; with its commodity uses competing inevitably and increasingly with its monetary uses; and with residual noncommercial availability in no way related to the liquidity needs of a prosperous and expanding international economy, the world has naturally developed supplements and substitutes.

The current situation—where speculative pressures on a thin and volatile commodity market have led to a price much higher than the official gold price—is evidence of the instabilities and tensions inherent in a system based on gold or other commodities. In 1972 alone, the commodity price of gold varied between $44 and $70—a difference of 60 percent of the lower figure. Whatever the established monetary price of gold, it is certain to get out of line with the price tendencies prevailing on the private market. Care must be taken to avoid exposing the reformed monetary system to that source of instability.

THE INTERNATIONAL TRADING SYSTEM

A new round of multilateral trade negotiations within the framework of the GATT is scheduled to begin in the fall of 1973. The purpose of these negotiations will be both to expand the scope for international trade and to improve the institutional process for resolving international trade disputes. The world as a whole, including the United States, has benefited substantially from the expansion of trade made possible by previous multilateral reductions of trade barriers. At the same time, conflicts over trade issues have intensified in recent years. In the approaching trade negotiations, new ways will have to be found to resolve such conflicts in ways conducive to the growth of trade.

World trade expanded more than fivefold in the last 20 years, and this expansion has been accompanied by an equivalent expansion of world output. The average annual growth in the value of both world trade and economic output during this period was about 8 percent. While the expansion of trade was only one reason for these output gains, it was undoubtedly an important source of growth. Trade not only allows each country to produce what is best suited to its capabilities, it also provides competition which stimulates everyone to produce goods more cheaply and to improve their quality.

Although the United States is less dependent on trade than most other nations, the role of trade in the economy has grown. Over the last two decades, GNP in the United States has increased about three and one-half times, while trade has increased more than four times. Exports have become a more significant source of employment and income for those sectors in which the United States has a comparative advantage, particularly agriculture and high technology manufactures, while imports are becoming more important as the source both of the raw materials and fuels used by U.S. industry and of consumer goods whose production requires much use of relatively unskilled labor.

Over the last 5 years, imports of goods by Americans have increased much faster than foreign purchases of goods made in the United States. This imbalance has caused difficulties for the United States as well as for the world economy, and its correction is therefore in the interest of both. It can be accomplished in part through equilibrating changes in exchange rates and relatively more effective anti-inflationary measures in the United States, both of which change relative prices and thus improve the competitiveness of U.S. goods and services. Much progress has been made on this front in the past 18 months. Reductions in foreign trade barriers can also contribute to correction of the payments imbalance. A number of countries, particularly Japan, took some liberalizing actions in 1972 aimed at alleviating the disequilibrium situation. It is hoped that further actions during 1973 will contribute to this adjustment process.

Aims of Trade Negotiations

The trade negotiations scheduled to begin in the fall of 1973 look to the longer term. Their goal is to remove the sources of difficulties that have arisen under present trading arrangements and to provide for the expansion of trade on the basis of mutual advantage and mutual commitment with reciprocity. However, results from the negotiations in the form of concrete changes affecting the world trading system are likely to be gradual and will not begin to take effect for several years.

In approaching these negotiations the United States seeks, as it has since the end of World War II, a more open and equitable world trading system. A freer movement of goods, services, and capital throughout the world in response to market forces is in the U.S. interest for several reasons. To the extent that trade is undistorted by artificial barriers, our producers can sell what they make best and our consumers will reap the benefits of efficient production and competition on a worldwide basis. These benefits to the United States will not conflict with the interests of other countries. All countries can expect gains from expanded world trade on a nondiscriminatory basis.

A world trading system that minimizes trade distortions is also one of the important prerequisites for a smoothly functioning international monetary system. The more barriers that countries erect to the flow of goods, services, and capital, the more the adjustment of payments imbalances is focused on the narrower range of economic activity which remains free to respond to market forces. The result is to place heavy and uneven burdens of adjustment on particular sectors, often forcing countries to choose between accepting severe economic dislocations and postponing overall adjustment.

Comprehensive trade negotiations are made even more urgent by the accelerated liberalization of trade within the enlarged European Community and countries associated with it. This development will stimulate growth and increased trade among countries within Europe, and will make possible expansion of trade with the outside world as well. At the same time, when a group of countries eliminates trade barriers among themselves while maintaining them against the outside world, the immediate effect is to divert trade from outside suppliers to suppliers in member countries.

In the process of harmonizing their tariffs with the EC's common external tariff, the new members of the EC will be increasing some tariffs and reducing others. Under the rules of the GATT, compensatory tariff reductions must be offered for any increase in tariffs fixed in previous agreements. In the course of this year, the United States and others will negotiate with the EC over the amount of compensation considered adequate. But, such compensation will not be able to take full account of the new situation that has been created by the changes in European trading arrangements. Only a negotiated reduction in the general level of tariffs and nontariff barriers (NTB's) can effectively reduce the discrimination that results from the removal of trade barriers within Europe.

The expansion of the EC has also been accompanied by the negotiation of preferential trade agreements between the members of the European Community and a large number of other countries in Europe and Africa. Most of these agreements provide for preferential access for exports of both parties in each other's markets, thus inherently discriminating against exports of outsiders. This proliferation of preferential trade agreements threatens to erode the most-favored-nation (MFN) principle, which provides that all trade concessions agreed on between two or more countries be extended to all countries that adhere to the General Agreement on Tariffs and Trade. While the GATT permits formation of free trade areas or customs unions that involve the elimination of barriers on substantially all internal trade, it does not permit more limited selective preferential arrangements.

The MFN principle has been the cornerstone of the postwar liberalization of multilateral trade. By ensuring nondiscrimination in the application of trade barriers, it minimizes the inefficiency and distortions caused by such barriers. It also avoids trade diversion and thus injury to third parties from selective reduction of trade barriers. And finally, it makes possible a greater trade liberalization in the course of multilateral GATT negotiations by ensuring that any trade concession negotiated between two or more countries will be promptly extended to a large number of countries. For these reasons, it will be important to clarify the obligations assumed by GATT members with respect to the MFN principle.

In view of the increasing importance of nontariff barriers as tariff barriers are reduced, it is crucial that the movement toward a more open trading system be comprehensive, encompassing all forms of barriers to trade. Among the major types of NTB's that distort trade are quantitative import restrictions, export subsidies, restrictive government procurement policies, and discriminatory design and performance standards.

Negotiations covering such a wide range of issues will be difficult for a number of reasons: trade distortions may arise from otherwise legitimate domestic social policies; many of these practices are embedded in domestic laws; there is no simple basis for measuring reciprocity in tradeoffs between one type of NTB and another; and the feasible time schedule for concluding negotiations and implementing agreements is likely to vary widely from one NTB to another. Nonetheless, inclusion of these measures in future trade negotiations is essential; and considerable preparatory work, both technical and definitional, has already been done, in the United States as well as in a number of international groups and organizations.

Further steps toward trade liberalization should also be comprehensive in the sense that they encompass all economic sectors. From the point of view of the United States, it is particularly important that such negotiations include agricultural as well as industrial trade. Abundant natural resources and advanced farm management and technology give this country a comparative advantage which makes our farm products highly competitive in world markets. Our agricultural exports are estimated to have reached an all-time high of $9½ billion last year. With rationalization of the agricultural policies and liberalization of the related restrictive import policies maintained by most industrialized countries, the United States could realize its full potential for trade in this important sector.

Institutional Reforms

Certain institutional reforms would greatly help the movement toward a more open and more equitable trading system. The present GATT framework, which has served well for the liberalization of trade, particularly tariff barriers, now needs to be strengthened and modified. In particular, better procedures should be found to deal with difficulties and disputes arising out of changes in trade patterns and trading arrangements among particular countries.

The failure of institutional arrangements to deal effectively with this range of problems poses certain dangers. Countries that cannot find a satisfactory multilateral solution to their trade difficulties will increasingly be under pressure to adopt unilateral restrictive measures that make trade less free and are often discriminatory in their effect. Trade disputes that are not resolved promptly and in accordance with agreed rules also tend to create political problems at home that spill over into other areas and affect political and security relations among countries. Such trade disputes can also prevent the smooth functioning of the international monetary system, both by distorting economic flows and by undermining confidence in existing economic relationships.

Difficulties have arisen in the past with respect to measures which countries take to cushion the domestic impact of abrupt changes in trade patterns. Under the existing rules of the GATT, countries can take temporary measures to restrain imports when rapid increases threaten to disrupt domestic industry. A country imposing such restraints, however, is required to compensate other countries for any loss of trade that may result by making equivalent reductions in other trade barriers. These rules have proved unworkable in practice, and governments have tended to evade them.

In limited instances, the adjustment required by a change in trade patterns may be too large to be accomplished in a short time without excessive social, personal, and political costs. In such cases temporary restraints on the pace at which imports increase can provide time for the adjustment of domestic resources to take place in the most constructive and least painful way. These safeguards can also make it less likely that some countries will resist general trade liberalization, fearing that it would cause abrupt dislocations in particularly sensitive industries.

A number of proposals have been put forward for a new safeguard system which would assure that such measures are taken within the multilateral framework. If safeguard actions are negotiated on a multilateral basis, they are not nearly so likely to become a disguised form of protectionism as they are if they are imposed by individual countries without international standards. Under the proposed system, it would be possible for importing countries to restrain imports temporarily without compensatory reductions of other trade barriers. Such actions would, however, be subject to commonly accepted criteria, a procedure for international review, and provisions to prevent abuse of the system. The system should also include an understanding that temporary safeguards must be accompanied by effective domestic adjustments in the allocation of resources.

These various matters relating to reform of the international trading system were discussed over a 2-year period by the OECD High Level Group on Trade and Related Problems, a group of experts representing the major industrial countries. Its report, issued in the summer of 1972, addresses all the major issues concerning trade, including tariffs, nontariff barriers, unilateral safeguards, trade in agricultural products, involvement of the less developed countries, and East-West trade. Although there were divergences of opinion on some issues among the group, particularly on agriculture, a high degree of agreement was found on major substantive issues. The report emphasizes the desirability of further liberalization of world trade and points to the economic and political dangers inherent in a return to protectionism.

OTHER ASPECTS OF INTERNATIONAL ECONOMIC COOPERATION

The reform of the international monetary and trade systems will have a global focus, inasmuch as the scope and membership of both the International Monetary Fund and the GATT are worldwide. Not all problems that arise in international economic relationships can best be solved in a global framework, however, since many issues that arise are of special interest to certain groups of countries. In many cases institutional mechanisms have been created for the purpose of examining common problems or exploring common approaches, in other cases there exists only a focus for analysis.

The discussion below examines three sets of relationships that cut across trade and monetary lines. The first is concerned with problems that arise among the industrialized market economies as a result of the high degree of economic integration among them. The second focuses on the various dimensions of the monetary, trade, investment, and economic assistance relationships between developed and developing economies. The third looks at the problems that may arise as economic relationships expand between centrally planned economies and the rest of the world.

Domestic Policies Affecting Trade and Investment

International monetary and trade rules are focused on measures affecting the flow of goods and financial assets across national borders. They do not, on the whole, touch upon internal policy measures which are not directed to international transactions as such but which nevertheless affect the international location of economic activity. In an integrated world economy, however, measures taken in one country may have substantial effects on the allocation of resources in other countries, and conflict among policy objectives of various countries is therefore possible. These interrelations have reached a particularly advanced state among the industrialized market economies. For this reason, the Organization for Economic Cooperation and Development (OECD), whose membership comprises most of the industrialized market economies, provides a useful forum for discussions on questions of internal economic policies, their role in transmitting economic influences from one country to another, and their relation to international economic transactions.

A step toward intensified use of the OECD forum for such discussions was taken recently when the Executive Committee of the Organization met for the first time at higher political levels than before (Executive Committee New Style) to discuss new fields for possible cooperation. Just how the focus of this area of international cooperation will be delineated remains to be worked out, since it is not always possible to distinguish the matters that clearly belong in the international monetary or trade sphere from those relating primarily to internal policies. In particular, this latter area overlaps with nontariff barriers which affect international trade and also with capital controls related to the monetary adjustment process. Among the questions likely to fall within the purview of this area, however, are those concerned with national investment policies, including policies relating to multinational corporations.

At its recent meeting, the OECD Executive Committee New Style agreed to explore possible forms of cooperation on national policies affecting investment. Such policies are a particularly sensitive concern of all governments, representing an area where national interests can conflict. By subsidizing or otherwise encouraging some industries and not others, governments can affect the pattern of domestic production and international trade. Investment policies can thus be used to some extent as substitutes for trade policy measures. The use of either may distort relative prices and cause a less than optimal allocation of world resources. Although subsidies and trade restrictions can influence the location of production in similar ways, subsidies affect adversely the terms of trade of the country giving them, while trade barriers such as tariffs can shift the terms of trade in favor of the country which imposes them.

Subsidies are not the only internal policy measure affecting investment, production, and trade. Other frequently used policy tools are taxes, antitrust policies, regulatory policies, patent policies, and government procurement policies. There is a need to explore cooperatively the possibility of limiting the use of such policies where they severely affect other countries.

Another field of investment policy open to conflict among national interests is the matter of rules governing the ownership of capital, including land, productive facilities, and financial assets. No nation would readily surrender the right to implement such rules, but every nation has an interest in protecting its citizens from arbitrary treatment by other governments. Considerable cooperation in this area has already been achieved by the OECD, in particular in promulgating the Code of Liberalization of Capital Movements. Further progress would increase both efficiency and fairness in international economic relations.

Another item of common interest in the investment area is the multinational corporation. Multinational corporations transmit capital, technology, and management skills from one country to another. Their ability to manage resources in an international rather than a national market has tended to improve the overall efficiency of the world economy. Because their operations extend beyond the boundaries of any single nation, however, a number of jurisdictional questions arise, and with increasing frequency these corporations are believed—rightly or wrongly—to affect a country's ability to pursue and achieve its domestic economic objectives. Moreover, multinational corporations personalize what would otherwise seem to be impersonal market forces that transmit the impact of economic decisions from one country to another. For this reason, these corporations tend to become a focal point for problems faced by national governments as a consequence of the growing economic interdependence among nations.

The OECD may also seek to work out cooperative arrangements on such questions as regional policies, industrial policies, agricultural policies, general adjustment policies, regulations governing financial markets, and principles of taxation.

Industrialized and Developing Economies

One of the important objectives of reform is to create a more stable and mutually beneficial framework for economic relations between developed and developing countries. Both groups of countries can benefit from reducing the degree of arbitrariness in national decisions affecting international trade, investment, and aid. The approaching negotiations provide an opportunity for mutual commitments that will serve the common interest and can facilitate achievement of the commonly accepted goal of reducing the global gap in economic prosperity.

Developed and developing countries are dependent on each other in many ways. Developing economies are the source of a substantial proportion of the raw materials used by the industrialized economies, and increasingly the source of manufactures involving labor-intensive production methods as well. On the other hand, industrialized economies are the source of much of the capital equipment, technology, management skills, and financial capital needed by the developing countries to increase their production capabilities and provide the basis for long-term diversification of their economies.

Most developing countries are members of the International Monetary Fund. They are represented by nine members on the Committee of Twenty, which is mapping out a reform of the international monetary system. This participation should help assure that the new rules will work effectively on a global basis and will give due weight to the needs of the developing countries.

For developing countries, exports not only provide most of their foreign exchange, but are also an important means of achieving economies of large scale production in many industries. In order to increase their opportunities for trade, the United States supports the general reduction of tariff barriers in industrial countries to exports of developing countries. The United States is also actively encouraging the full participation of these countries in the approaching trade negotiations. The agenda for the negotiations, including such items as the reduction of nontariff barriers and the imposition of safeguards, covers matters of even greater concern to these countries than tariff questions. But their influence on the outcome of the negotiations will also be greater if countries which are not currently members of the GATT are willing to accept the obligations of GATT membership. The commitment to this framework of rules and obligations would help to ensure developing countries against arbitrary action by others. An obligation to avoid highly complex and discretionary nontariff barriers could also improve the efficiency of their own planning efforts and facilitate trade with each other, which has been declining in relative importance for many years.

The efficient transfer of capital from developed to developing countries is another important objective of a well-functioning international economic system. Such transfers of capital are desirable because they make available to developing countries more resources for investment, as well as giving them access to new production and management techniques. In recent years, there has been a reduction in the relative importance of bilateral economic assistance and increased reliance on the multilateral development banks as channels of public aid. Loans by these institutions have almost doubled in the 5-year period from 1968 through 1972, and U.S. contributions have also increased substantially. At the same time, U.S. bilateral economic assistance has declined slightly. Private capital flows from developed to developing countries have also continued to expand at a rapid rate, nearly doubling during the 5-year period from 1967 through 1971, the last year for which data are available. The size of these private flows makes it increasingly desirable to create arrangements which assure developing countries that such investments contribute to their economic advancement and assure developed countries that their investments will not be treated arbitrarily. Such arrangements should include internationally accepted standards and procedures for the settlement of disputes.

Market and Centrally Planned Economies

Trade and monetary relations between market economies and centrally planned economies have been carried on outside the framework of the multilateral trade and payments system, generally on the basis of bilateral trade agreements. These agreements may sometimes specify the quantities and prices of commodities to be exchanged. More often they are more open-ended, providing only a set of ground rules for trade contracts negotiated between individual state trading companies and private firms.

Trade between market and centrally planned economies can be advantageous for both sides, and with a relaxation of political tensions this trade can be expected to grow significantly. In the past the United States has engaged in less trade with the centrally planned economies than has western Europe. Recently, however, the United States has taken a number of steps to expand its trade with these countries; among such moves have been the signing of trade agreements with the Soviet Union and Poland and the elimination of the embargo on bilateral trade with the People's Republic of China.

Trade with the Soviet Union is likely to grow particularly fast. The Soviet Union has large quantities of raw materials and fuels, many of which are beginning to be in short supply in the United States. On the other hand, the Soviet Union has a large import requirement for food and for manufactured products that depend on advanced technology. The United States can supply both.

The particular characteristics of the centrally planned economies will require the development of special rules as trade between them and the market economies expands. In trade among market economies, bilateral settlement of claims has been abandoned in favor of a multilateral settlement system. Since few of the centrally planned economies are part of this multilateral payments system, special arrangements will have to be made to assure that settlements of net balances will be effected.

For trade among market economies, rules have also been developed to prevent excessive disruption of domestic production and trade with third countries by large and rapid shifts in trade patterns. As trade with the centrally planned economies grows, it may be necessary to develop similar rules to prevent sudden disruption not only of economic activity within individual market economies, but also of trade patterns among the market economies.

Finally, it is important to ensure that commercial disputes are settled amicably and are not allowed to spread into the political sphere. In trade among market economies, contracts are usually made between individual firms, and whatever disputes arise are settled through the respective courts in a manner that is usually acceptable to both parties. In trade with centrally planned economies, the fact that one of the parties to any trade contracts is the state can create special problems with respect to the settlement of disputes.

In anticipation of some of the possible problems that a rapid expansion of trade could give rise to, the recent trade agreement between the United States and the Soviet Union included these provisions:

1. The creation of a joint U.S.-U.S.S.R. Commercial Commission to resolve difficulties arising at the government level.

2. A procedure for guarding against market disruptions. Under it, after consultation, the U.S.S.R. will not ship products to the United States which the U.S. Government has advised will "cause, threaten, or contribute to disruption of its domestic market."

3. An arbitration agreement which encourages the settlement of commercial disputes by arbitration in a country other than the Soviet Union or the United States under the Arbitration Rules of the Economic Commission for Europe, a United Nations agency. The U.S.-Soviet trade agreement also provides for the reciprocal extension of credit facilities, nondiscriminatory tariff treatment of each other's imports, the establishment of commercial offices in the two countries, the availability of business facilities, and the settlement of the World War II lend-lease debt owed the United States by the U.S.S.R.

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In advancing proposals for reform, the United States has kept in mind the necessity of building on commonly accepted principles. Foremost among these principles is the belief that an open exchange of goods, services, and capital based on market relationships can benefit all countries. Moreover, if all countries are to remain committed to freer trade and investment, the international rules must give everyone a chance to share in the benefits. Recent experience has shown the need for certain reforms in current rules and practices. The rules should more explicitly define international standards of conduct and yet provide greater flexibility in the means of discharging these international responsibilities. Also, the various aspects of the international economic system dealing with monetary, trade and investment questions should be better related to each other. Lastly, any stable and well-functioning international economic system must rest upon sound domestic policies to promote domestic growth and price stability in the major countries.