Monetary Policy and the U.S. Economy in 1971

A Prelude to the Annual Report

Federal Reserve System Board of Governors

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

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Introduction

In 1971 monetary policy encouraged further substantial growth in bank reserves, money, and bank credit in helping to stimulate economic recovery from the mild recession of 1969–70. Monetary aggregates in general expanded somewhat more rapidly than they had the year before. Interest rates fluctuated widely—reflecting, among other things, shifts in inflationary expectations and large flows of funds between the United States and foreign countries. After the President's mid-August announcement of new economic policies, which included a program of wage and price restraint and far-reaching international measures to combat inflation and the deterioration in the balance of payments, interests rates showed a declining trend, and at the end of the year they were down somewhat, on the average, from their beginning-of-1971 levels.

For 1971 as a whole the real gross national product rose only 2.7 per cent from the year before. Greatly increased spending for residential construction and larger expenditures by State and local governments helped to sustain economic activity. But economic recovery was hampered by domestic and international economic uncertainties and generally cautious attitudes on the part of both businesses and consumers. Unemployment remained at about 6 per cent of the labor force throughout the year. And prices, as measured by average prices of the goods and services that make up the GNP, rose about as much in the first half of the year, prior to the new economic program, as they had in 1970.

During the first half of the year, surveys of consumer attitudes suggested that concern about rising prices, as well as fear of unemployment, was causing consumers to hold back on spending. Consumer outlays for goods and services did rise rather substantially, but the increase reflected in large measure the first-quarter bulge in disposable personal income and auto sales following settlement of the late-1970 auto strike, a Federal pay raise, and retroactive increases in social security benefits. The personal saving rate remained exceptionally high.

With the strength of consumer spending uncertain, businessmen pursued conservative inventory policies, although there was some strike-related inventory-building during the first half of the year. In addition, outlays for new plant and equipment were held down by the sizable amount of excess manufacturing capacity already in place and by the sluggishness of new orders for the output of these plants. Defense and nondefense orders from the Federal Government remained at a reduced pace. The cumulative effect of rising costs and prices limited the ability of U.S. industries to compete in foreign markets, and in many cases to compete in domestic markets with goods produced abroad.

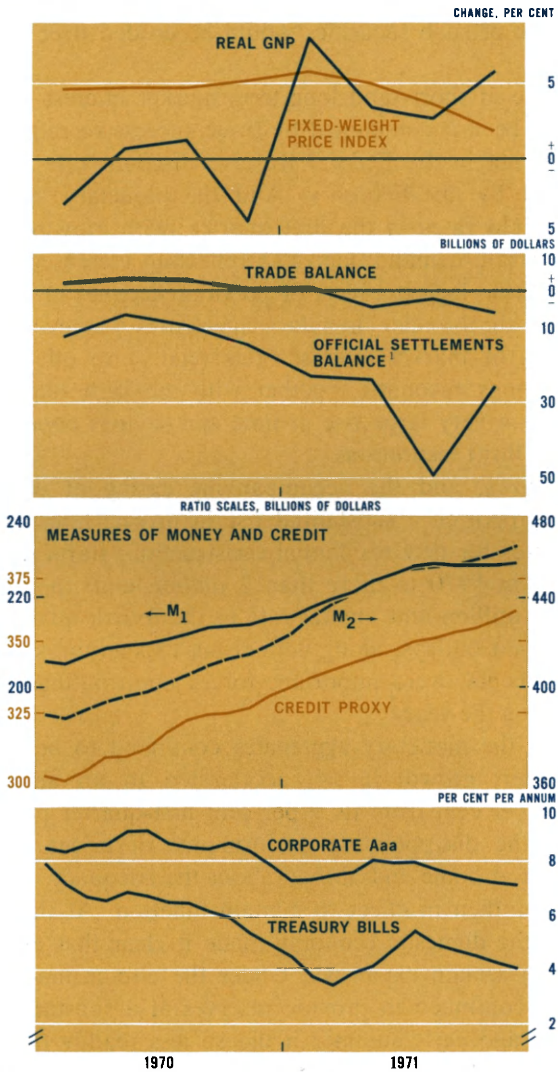
During 1971 the U.S. balance of payments worsened dramatically. The trade balance was only marginally in surplus in the early months of the year; then it slipped into monthly deficits, making increasingly evident the extent to which the competitive position of the United States had eroded.

The worsening of the over-all balance of payments reflected also the very large outflows of capital from the United States to foreign countries that occurred in response to interest rate incentives and expectations of changes in currency values. In the early part of the year U.S. interest rates declined much faster than those in leading financial centers abroad, and U.S. banks continued to repay Euro-dollar borrowings. Foreign official reserves were swollen by these and other recorded and unrecorded flows of capital. German reserve gains were especially large until the German mark was permitted to float upward in May. As evidence of deepening difficulties for the U.S. balance of payments mounted, international traders and investors shifted out of dollar assets into other currencies on a large scale.

From the end of 1970 to the end of July 1971, U.S. liabilities to foreign official accounts increased by $12.5 billion to a level of $37 billion, while U.S. reserve assets fell by a little more than $1 billion to $13.3 billion. In the first 2 weeks of August reserve liabilities grew by a further $4.5 billion, while reserve assets dropped by another $1 billion.

The worsening in the balance of payments situation heightened public concern about the effectiveness of policies being pursued to contain inflation—a concern that was related to the continuation of large wage settlements and to the lack of evidence that price increases were abating to any significant extent. Interest rates—which had declined further in the very early months of the year—began to

1. SELECTED ECONOMIC DEVELOPMENTS



[1] Excludes SDR allocations.

NOTE.—GNP and price data are based on seasonally adjusted annual rates data from Bureau of Economic Analysis, Dept. of Commerce; changes from preceding quarter at compounded annual rates; fixed-weight price index is for gross private product. For definitions of measures of money and credit, see Chart 12, p. 34; for Treasury bills and Aaa bonds, see Chart 11, p. 32.

rise. Long-term rates in particular were affected by renewed resistance to fixed-income securities on the part of investors who feared that the value of such securities would be eroded over time through inflation.

The decline in short- and long-term market interest rates early in the year had been accompanied by three successive reductions of ¼ percentage point in the Federal Reserve discount rate, to a level of 4¾ per cent by mid-February. And the monetary aggregates expanded at rapid rates in the first quarter, with growth in M_1 (currency and private demand deposits) reflecting increased transactions demands and the lagged effects of previous declines in interest rates. Expansion in the broader monetary aggregates was even more rapid as low levels of market interest rates relative to offering rates on time and savings accounts, together with the high rate of personal saving, led to a very large rise in time and savings deposits at banks and nonbank thrift institutions.

These inflows, and the accompanying easing of over-all credit conditions, supported a substantial rise in private housing starts and in expenditures for new residential construction; starts rose from 1.4 million units in 1970 to more than 2 million units in 1971 and exceeded a 2.2-million-unit annual rate in the fourth quarter. Residential construction outlays, along with rising expenditures by State and local governments, were important forces contributing to economic recovery during the year.

Growth in the monetary aggregates continued to be rapid in the second quarter; growth in M_1 accelerated to an annual rate of around 10.5 per cent from its 9 per cent first-quarter pace. This, together with the disappointing performance of prices, was causing some concern at home and abroad about the adequacy of public economic policies then in effect to contain inflation. At the same time, the slack in the domestic economy made it clear that monetary policy needed to remain expansive. Under the circumstances, the Federal Reserve continued to provide reserves at a substantial rate, but in the spring and early summer it did so less readily than earlier in the year. This policy contributed to the rise in short-term rates that developed during the second quarter. To bring the discount rate into better alignment with market rates, the rate was raised by ¼ of a percentage point in mid-July to 5 per cent.

In an effort to maintain accommodative capital market conditions, in view of the comparatively weak expansion of the economy, the Federal Reserve stepped up its purchases of longer-term Treasury securities during the first quarter. Later in the year, it extended its outright purchases of securities in the open market to include Federal agency issues. These operations were adopted within the over-all objectives of System open market operations, and they did not contribute, net, to faster growth in the System's total portfolio of securities or to expansion in bank reserves.

Developments over the first 7 months of the year brought increasingly into question whether conventional monetary and fiscal policies alone were adequate to combat the cost-push inflation and the deterioration in the U.S. balance of payments, while at the same time continuing to promote more vigorous recovery in the domestic economy. The new economic policies initiated in mid-August broadened the mix of public policy measures with a view to dealing more effectively with the Nation's diverse and, in the short run, partly conflicting objectives.

The basic elements of the new program were a temporary 90-day freeze on wages and prices, to be followed by a more flexible system of restraints in the second phase; suspension of the convertibility of the dollar into gold or other reserve assets; imposition of a temporary surtax of up to 10 per cent on dutiable imports; and certain fiscal measures designed to stimulate spending, including proposed elimination of the excise tax on autos and an investment tax credit to encourage business capital outlays. The program of tax incentives, with some modifications, was enacted by Congress late in the year, as was legislation authorizing the continuation of a program of restraint on wages, prices, rents, dividends, and interest. The 10 per cent surtax was rescinded following the international monetary agreement reached on December 18 in Washington.

The new economic program recognized the need for a sizable and broadly based revaluation of foreign currencies vis-a-vis the dollar to help restore the international competitiveness of U.S.-produced goods. But in addition the new program was intended to encourage improvements in the Bretton Woods Agreements and to eliminate at least some of the major foreign trade practices injurious to U.S. exports. After August 15 all major countries allowed their currencies to rise somewhat in price relative to the dollar, although foreign official institutions added substantially more to their holdings of dollars.

The monetary agreement signed in Washington in mid-December allayed international uncertainties that had threatened to impede the flow of trade and to hinder U.S. economic recovery. Major foreign countries agreed to an adjustment of exchange rates, the over-all effect of which was to produce a substantial appreciation, on the average, of foreign currencies in relation to the dollar. The settlement also included a widening of intervention bands to 2¼ per cent on either side of the new exchange rates (or parities) as well as an increase of 8.57 per cent—from $35 to $38 per ounce—in the dollar price of gold to be requested from Congress.

The new domestic and international economic program was immediately reflected in renewed confidence in credit markets. After mid-August, interest rates declined as inflationary expectations abated and as fears eased that the worsensing balance of payments might lead to tighter financial conditions in the United States.

The new wage-price program effectively constrained wage and price increases during the freeze period. After the freeze ended in mid-November, some catch-up of wage and price increases developed. The Phase II program of wage and price restraint is being administered by a Pay Board and a Price Commission. The activities of these two bodies, composed of private citizens, are coordinated by the governmental Cost of Living Council. The objective of the Phase II program is to hold average price increases to no more than 2.5 per cent per year, in conformity with the Council's goal of reducing the rate of inflation to a range of 2 to 3 per cent by the end of 1972. Such an achievement would halve the rate of inflation that had prevailed in 1970 and the first half of 1971. A Committee on Interest and Dividends was also formed as part of the Phase II program to see that the behavior of dividends and interest rates—particularly those that affect the American family, such as on mortgages and consumer loans—is consistent with the program of wage and price restraint.

The initial effects of the new economic program appear to have been stimulative. Immediately after announcement of the price freeze, there was a surge in purchases of new domestically produced autos, and consumer purchases of other goods and services, in real terms, also quickened. Employment gains accelerated as did the over-all rate of economic activity. In the final quarter of the year, real GNP rose at an annual rate of around 6 per cent, notably faster than in the second and third quarters and the highest rate of gain, except for the strike-recovery period in the first quarter of 1971, since the first half of 1968.

Monetary developments in the latter part of 1971 were highlighted by moderation in the growth rates of the monetary aggregates. In particular, the level of the narrowly defined money stock (M_1) showed only a very minor increase from August to December. Following the sharp build-up earlier in the year, when economic uncertainties were pervasive, the public's demand for cash balances leveled off, reflecting in part reductions in precautionary demands for liquidity as confidence increased. The broader measures of money continued to expand at substantial rates in the latter part of the year, although in these too the rate of growth moderated somewhat from the rapid rates that had occurred in the first half.

At the same time sufficient bank reserves were being provided to encourage the interest rate declines initially set in motion by the wage-price freeze. By the year-end longer-term interest rates were about 1 percentage point below their mid-August levels, and short-term rates were down by about 1.5 percentage points over the same period. And in mid-December the discount rate was reduced to 4½ per cent in recognition of the lower levels of market interest rates and to assist in encouraging a more rapid economic expansion.

Developments in 1971 laid the basis for an accelerated rate of economic recovery in 1972 and for further moderation of wage and price pressures. To be sure, effective administration of the Phase II wage and price program will be critical in maintaining public confidence in the containment of inflation. But this result should be encouraged also by basic economic forces, including continuation of an ample supply of labor and materials, the absence of demand-induced inflation generally, and the prospect that faster growth in productivity is likely to accompany more vigorous expansion in over-all economic activity.

The outlook for a strengthening in demands for goods and services appears highly favorable. Plant and equipment surveys suggest greater capital outlays by business in 1972 than in 1971. Moreover, the realignment of exchange rates should make domestically produced goods more competitive, thus enhancing the potential for exports by U.S. firms and perhaps shifting investment plans toward the United States. And corporations are now in good financial positions to expand operations—having worked over the past 2 years to restructure their debt and to improve their liquidity positions.

Residential construction outlays should increase somewhat further in 1972, given the rising rate of housing starts in the latter part of 1971. The currently ample liquidity of banks and other financial institutions and the continuation of large net inflows of time deposits suggest that credit will be available to finance construction activity—even if there is a pick-up in business loan demands at banks. State and local governments are also likely to increase their spending for construction; these governments issued very sizable amounts of securities in 1971, and according to preliminary indications their demands for funds will continue to be large in early 1972. Furthermore, the Federal budget indicates a stimulative fiscal policy during 1972.

An acceleration of economic recovery will depend importantly on a strengthening in consumer demands. The saving rate declined somewhat in the latter part of 1971, suggesting an increased consumer propensity to spend and greater confidence in the longer-run economic outlook. Increases in consumption together with increases in construction, investment, and net exports would be likely to stimulate increased holdings of inventories since businesses have followed comparatively conservative policies in this type of investment over the past 2 years. Such a pick-up in inventory accumulation has been a major feature of past cyclical recoveries, when it has played a significant role in inducing gains both in employment and in consumption expenditures.

Other sections of this report analyze developments in certain key areas of the economy in 1971. A digest of the principal Federal Reserve policy actions in 1971 appears on pages I–VII following page 28. □

Wages, Prices, and Productivity

On the basis of past experience, the continued slack in labor and product markets that typified the year 1971 should have generated a pronounced slowdown in the rate of inflation. However, that did not happen. Whereas the rate of price increase did moderate in some sectors early in the year, much of the improvement reflected the influence of special factors instead of the usual forces of demand and supply. In general, wages and prices continued to increase at a rapid rate throughout the first half of the year. Workers sought higher wage increases to make up for past reductions in real purchasing power and to protect future gains in wages from expected further inflation. But businessmen too expected that inflation would continue, and since their profit margins were already low, they passed the higher labor costs on in the form of higher prices, where possible.

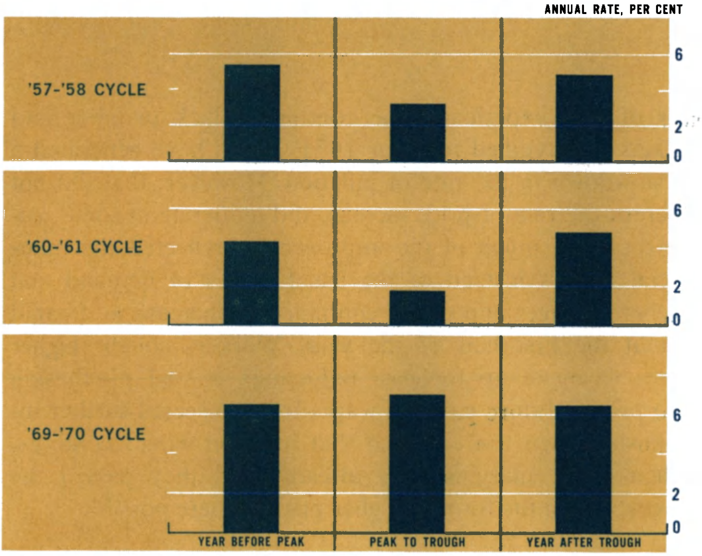
WAGES

Despite the relatively large amount of unemployment, compensation per manhour continued to grow at a rapid pace in the first half of 1971. Average hourly compensation in the private nonfarm economy increased at an annual rate of 7.2 per cent in this period, slightly higher than the 7.0 per cent increase for 1970 as a whole. Relatively large wage gains occurred in most industries, with the greatest being in contract construction and in transportation and public utilities. In manufacturing, average hourly earnings—after allowance for changes in the industrial composition of factory employment and for overtime —increased at a rate of 7.0 per cent in the first 6 months of 1971.

One factor contributing to the high rate of wage increases was the disproportionately large number of major long-term contracts expiring and new settlements negotiated in the latter part of 1970 and in the first half of 1971, including contracts in such highly visible and pattern-setting industries as autos, railroads, containers, and communications.

Another factor was that wage increases of many union workers, particularly in the manufacturing sector, had lagged behind price in-

2. COMPENSATION PER MANHOUR
Changes in Recent Business Cycles



NOTE.—Bureau of Labor Statistics data, seasonally adjusted, for private nonfarm economy. Periods covered are as follows:

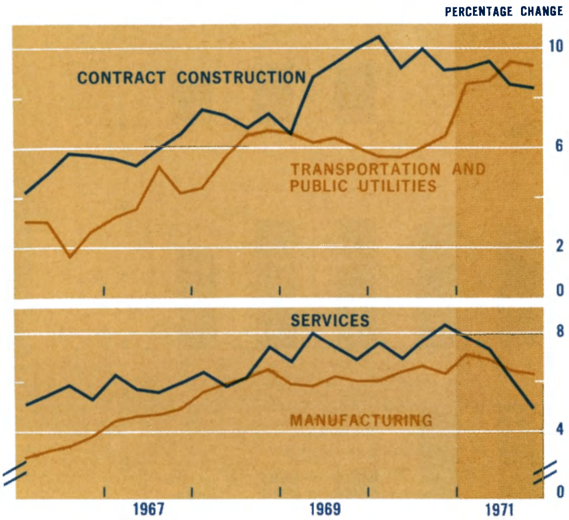
	1957–58 Cycle	*1960–61 Cycle*	*1969–70 Cycle*
Year before peak	1956 III–1957 III	1959 II–1960 II	1968 IV–1969 IV
Peak to trough	1957 III–1958 II	1960 II–1961 I	1969 IV–1970 IV
Year after trough	1958 II –1959 II	1961 I –1962 I	1970 IV–1971 IV

creases in the late 1960's. Consequently, there was strong pressure by union members to catch up on their wages. As a result, contracts were front-loaded—that is, they had larger increases in the first year than in following years. In manufacturing, first-year increases averaged 8.7 per cent in the first half of 1971; in nonmanufacturing, they were smaller than in 1970 but were still considerably larger than in manufacturing.

Contract settlements in the construction industry, which had been exceptionally high in recent years, moderated somewhat during 1971; this apparently reflected the efforts of the Construction Industry Stabilization Committee, which was set up in March 1971. Nevertheless, wage increases allowed in the construction industry continued to be much higher than the average for all workers.

A slowing in wage increases did become evident in some sectors. In trade and services, which are typically not unionized, the rate of advance in wage rates declined somewhat; among nonunion workers

3. AVERAGE HOURLY EARNINGS



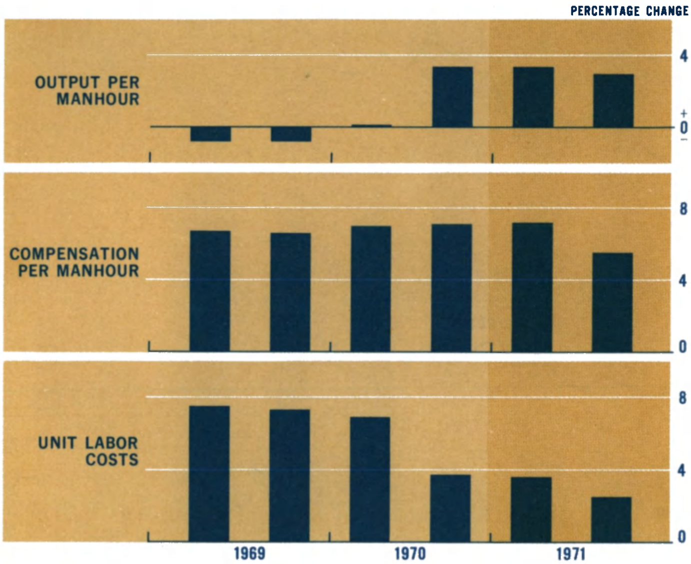
NOTE.—Change from corresponding quarter a year earlier, calculated from BLS data without seasonal adjustment.

in manufacturing also, wage increases moderated and were less than for union workers. Still, movements in wage rates in 1971 generally continued to respond less to slack demands for labor than in previous periods of relatively high unemployment.

PRODUCTIVITY AND UNIT LABOR COSTS

Despite continued rapid increases in wages, pressures on unit labor costs eased somewhat in the first half of 1971 as a result of a faster growth in productivity. Output per manhour in the private nonfarm economy rose at an annual rate of about 3.5 per cent in the second half of 1970 and the first half of 1971, after showing no gain in late 1969 and early 1970. Productivity increases for the manufacturing sector of the economy were slightly higher. The higher rate of productivity gains stemmed mainly from cost-cutting efforts by business, which sought to restrict increases in employment even after demand and output had started to expand. Hence, increases in unit labor costs slowed from a peak annual rate of more than 6 per cent for the private nonfarm economy in 1970 to about 3.5 per cent during the first half of 1971. Even though cost pressures were reduced,

4. OUTPUT PER MANHOUR AND RELATED DATA



NOTE.—Changes, expressed at annual rates, are based on half-year averages of BLS data for the private nonfarm economy.

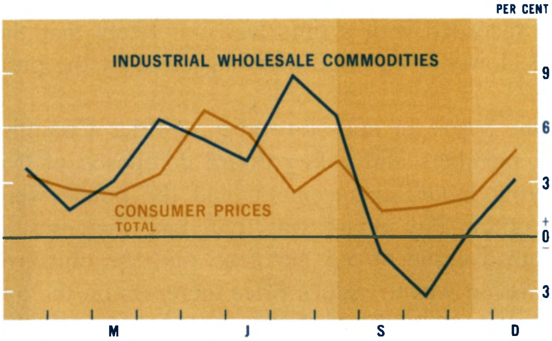
they were still strong enough to generate unacceptably high rates of price increase—since business was experiencing unusually low profit margins and was unwilling or unable to absorb higher costs.

PRICES

Against this background, only a few signs of abatement in the rate of price inflation were apparent during the first half of 1971. A significant reduction did occur in the rate of increase of consumer prices in the first quarter of 1971, but this improvement reflected in large part a decline in mortgage rates. In the second quarter the general level of consumer prices resumed a more rapid upward movement, increasing consumer and business doubts that inflation would be brought under control in the near future.

Wholesale prices of farm products and food began to rise again in early 1971. Inflationary tendencies were further intensified by a resurgence in the second quarter of price increases for industrial prod-

5. PRICES IN 1971



NOTE.—Month-to-month changes at compounded annual rate.

ucts included in the wholesale index; prices of these products had leveled off in the second half of 1970 and in early 1971. The resurgence reflected in part an upturn in the prices of materials. Prices of construction materials accelerated sharply as the housing boom gained momentum, and steel prices were increased in response to the build-up in inventories and in anticipation of higher labor costs.

The fixed-weighted deflator for gross private product—the broadest measure of the prices of goods and services produced in the private economy—also showed a continued rapid rate of increase. In the first half of the year the rise was at an annual rate of 5.4 per cent, more than the increase in 1970.

EFFECT OF THE NEW ECONOMIC PROGRAM

The acceleration of price increases in the second quarter was a factor in the re-evaluation of economic policy. The new economic program announced by the administration in mid-August included, as noted earlier, measures that temporarily stabilized wages and prices as part of a package to restrain inflation while promoting faster economic growth and restoring the basis for balance of payments equilibrium.

The 90-day wage-price freeze included in the program was quite effective. Gross hourly earnings of private nonfarm workers rose at an average annual rate of only 2.3 per cent between August and November. Wholesale prices of industrial commodities actually declined during this period, while the rise in consumer prices slowed to a 1.7 per cent annual rate. Moreover, since some price changes in the consumer price index are recorded with a time lag, it is likely that the rise in consumer prices slowed even more than suggested by the published figures.

Before the end of the freeze in mid-November, a Price Commission with seven public members and a Pay Board composed of five representatives each from labor, management, and the public were established. The goal of the Pay Board was to reduce increases in annual wage rates to an average of 5.5 per cent, and the objective set by the Price Commission was to reduce price increases on the average to a rate of no more than 2.5 per cent—a rate consistent with the Pay Board's guideline, given the expectation of a growth in productivity at the long-term average rate of about 3 per cent per year. The Price Commission stated that price increases generally would be allowed to cover cost increases, but only after productivity gains had been taken into account, and only so long as profit margins did not rise above the average of any two of the previous three fiscal years.

It was expected that after the end of the freeze there would be a period of transition—one in which wage and price increases would exceed the guidelines in part because of a bunching of increases deferred during the freeze. Also, in the early months the Pay Board was expected to have difficulty holding wage increases within the guideline because of wage contracts previously negotiated that called for either deferred or retroactive increases of more than 5.5 per cent. In December, the first full month after the freeze, average gross hourly earnings for private nonfarm workers increased at an annual rate of 6.8 per cent.

By the end of the year only a few decisions had been announced by the Pay Board. In the decisions covering coal miners and railway signalmen, wage increases well above the guideline were allowed because the contract settlements had occurred prior to the end of the freeze. For aerospace workers, the Board rejected a 12 per cent, first-year wage increase negotiated in a new contract concluded after the freeze and limited any increase in a new contract to 8.3 per cent. The contracts considered by the end of 1971 covered only a minor portion of the work force. Moreover, a vast majority of workers are employed by small companies that are excluded from the prenotification requirement. Thus, it is still too early to judge the ultimate effectiveness of Phase II in limiting wage rate increases.

The Price Commission requires that large firms give notification of intended price increases, and by the end of December a large number had filed such applications. The Commission appears to have had some success in reducing requested price increases. Moreover, in some instances where price increases were approved by the Commission, they have not been put into effect, due to competitive pressures. However, as expected, an acceleration of price increases occurred in the immediate postfreeze period. In December, the increase for consumer prices was 4.7 per cent at a compounded annual rate (Table 1); and for all commodities excluding food, it was 4.2 per cent. Wholesale prices of industrial commodities advanced at an annual rate of 3.2 per cent, with about half of the increase reflecting a rise in prices of autos and trucks. The implicit deflator for GNP rose at an annual rate of only 1.5 per cent in the fourth quarter—reflecting mainly the effects of the freeze.

In the second half of 1971, productivity rose at a 3.0 per cent annual rate in the private nonfarm economy while the rise in compensation per manhour slowed to a 5.5 per cent annual rate. As a result, the increase in unit labor costs was reduced to a 2.5 per cent annual rate. As economic activity continues to expand, productivity gains at least as large as those experienced in 1971 seem likely.

Table 1: PRICE CHANGES

Per cent

Series	Year				1971, compounded annual rate		
	1968	1969	1970	1971	Dec.–Aug.	Aug.–Nov.	Nov.–Dec.
Wholesale prices, total	2.5	3.9	3.7	3.2	5.1	−0.8	8.9
Industrial commodities	2.6	3.3	3.8	3.6	4.9	−1.3	3.2
Farm products, processed foods, and feeds	2.4	5.4	3.4	2.0	5.9	..	28.2
Consumer prices, total	4.2	5.4	5.9	4.3	3.8	1.7	4.7
Food	3.6	5.1	5.5	3.0	4.7	1.7	8.3
Other commodities (less food)	3.6	4.2	4.2	3.8	2.4	..	4.2
Services	5.2	6.9	8.1	5.6	4.5	3.1	3.7

NOTE.—Based on Bureau of Labor Statistics data.

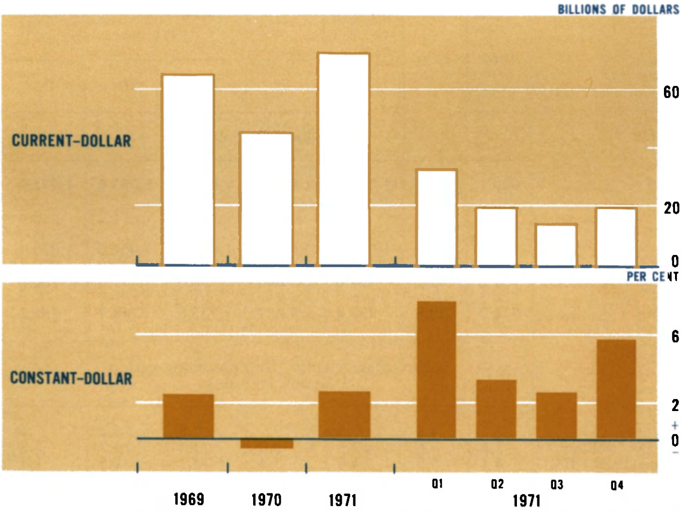
Wage pressures should be less in 1972 than in 1971, particularly if price increases are smaller. Most of the Pay Board's decisions relating to large contracts associated with the pre-freeze round of bargaining should be resolved early in 1972, and fewer major labor contracts are scheduled to be negotiated than in 1971. In addition, wage increases scheduled in existing contracts are smaller for the second and third years than for the first. If wage pressures are moderated and productivity gains are relatively strong, unit labor costs should come under appreciably better control. Moreover, such a slowing of the rise in labor costs would help to limit price increases. As price increases moderate, worker demands for wage increases in anticipation of future inflation should also abate, and thereby assist the Pay Board and the Price Commission in achieving their goals.

Demands for Goods and Services

The expansion in demands for goods and services was quite modest during 1971. The year began with an upsurge in real GNP, which increased at an 8 per cent annual rate in the first quarter following a 4 per cent decline in the preceding quarter. But this rise reflected in considerable measure a rebound in auto output and sales after the end of the auto strike in late 1970.

In the second quarter the increase in real GNP was less than half as large as that in the first quarter despite an impressive gain in residential construction activity and stockpiling of steel inventories in anticipation of a possible strike in midsummer. Federal defense spending continued to be cut, and a further deterioration in U.S. foreign trade eliminated the positive balance in net exports of goods and services.

6. CHANGE IN GNP



NOTE.—Based on quarterly data (seasonally adjusted annual rates) from BEA, Dept. of Commerce.

Gains in industrial production were slight, growth in employment was slow, and unemployment remained at around 6 per cent of the civilian labor force. Furthermore, prices continued to increase rapidly during the first half.

The new economic program introduced on August 15 led to an improvement in the outlook for economic activity. There were signs that consumer confidence improved in response to the strong measures taken to control inflation. The prospect for consumer spending was favorably affected by this as well as by fiscal measures included in the program, such as proposals to remove the excise tax on autos and to advance to the beginning of 1972 certain personal tax reductions previously scheduled for 1973. Prospective business spending on capital goods was encouraged by a proposed investment tax credit. The fiscal elements of the program were enacted, with some modifications, by Congress in December.

Final sales, measured in real terms, rose somewhat more rapidly in the third quarter than in the second, spurred by a sharp increase

Table 2: GROSS NATIONAL PRODUCT

Item	1969	1970	1971	1971 I	1971 II	1971 III	1971 IV
	In billions of dollars [1]						
GNP, current dollars	929.1	974.1	1,046.8	1,020.8	1,040.0	1,053.4	1,072.9
Inventory change	7.4	2.8	2.2	3.1	4.6	−1.2	2.4
Final sales	921.7	971.3	1,044.5	1,017.7	1,035.4	1,054.6	1,070.4
Private [2]	822.6	874.1	946.9	921.4	939.4	957.0	970.1
Federal	99.2	97.2	97.6	96.4	96.0	97.6	100.3
GNP, constant dollars	724.7	720.0	739.4	729.7	735.8	740.7	751.3
	Percentage change from preceding period (at annual rates)						
GNP in current dollars	7.5	4.8	7.5	13.7	7.8	5.2	7.6
GNP in constant (1958) dollars	2.6	−.6	2.7	8.0	3.4	2.7	5.8
GNP implicit deflator (1958=100)	4.8	5.5	4.6	5.4	4.2	2.5	1.7

[1] Quarterly data are seasonally adjusted annual rates.
[2] Adjusted to include State and local governments.
NOTE.—Basic data from Department of Commerce, BEA.

in purchases of domestically produced autos after announcement of the new economic program. However, liquidation of inventories, particularly excess steel stocks, resulted in a further slowing of the growth in GNP (Table 2). Late in the year over-all economic activity accelerated as inventory accumulation was resumed, as outlays for residential construction continued to rise, and as the rate of real business capital spending picked up. Surveys made late in the year indicated that businesses planned a sizable increase in outlays for plant and equipment in 1972.

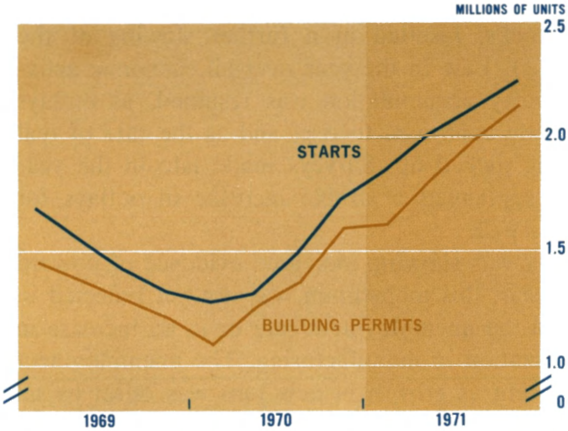
Although the economy was showing increased evidence of upward momentum late in the year, this momentum was not yet reflected in a significant reduction in the unemployment rate or in an increase in the rate of capacity utilization in manufacturing. The unemployment rate remained at 6 per cent as growth in new jobs was offset by an increase in the number of new jobseekers.

RESIDENTIAL CONSTRUCTION

Residential construction continued to expand vigorously throughout 1971, as mortgage funds were in ample supply and interest rates were declining. Private housing starts rose from an average annual rate of 1.3 million units in early 1970 to an average rate of 2.2 million units in the final quarter of 1971. For the year as a whole, such starts approached 2.1 million units—a new high, which surpassed by 7 per cent the record that had stood since 1950. There was some shift in the mix away from the smaller, less expensive single-family homes that had characterized the market in 1970 when subsidized units had accounted for a larger proportion of the total. But builders continued to feature a high proportion of townhouses and apartments in an attempt to offset higher land and construction costs. In addition to the record number of housing starts, shipments of mobile homes reached one-half million units, which also represented a new high.

The improvement in housing starts was reflected in strong increases in residential construction expenditures, which were still rising as the year drew to a close. Spending for new homes also helped to keep consumer outlays for such durable goods as furniture and appliances on a generally upward path. For 1971 as a whole overall expenditures for residential construction were some $10 billion,

7. PRIVATE HOUSING ACTIVITY



NOTE.—Bureau of the Census monthly data at seasonally adjusted annual rates, converted to quarterly averages by Federal Reserve.

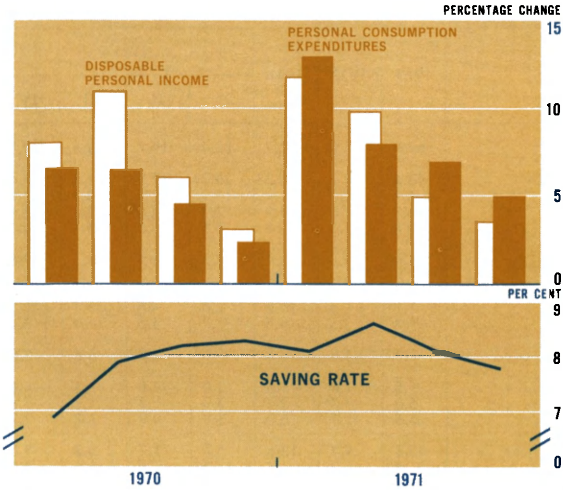
or 34 per cent, larger than in 1970; in real terms this represented a gain of about 27 per cent.

CONSUMER INCOME AND OUTLAYS

Because of tax cuts, a Federal pay raise, and an increase in wages and salaries that reflected the resumption of auto production and related activities following the strike, disposable personal income rose by more than $20 billion in the first quarter of 1971, almost twice the average quarterly increase in 1970. The rise in consumption almost equaled that in disposable income, with more than half of the increase being attributed to renewed auto buying. Sales of domestic-type autos in the first quarter were at an annual rate of 8.4 million units—up sharply from the 5.4 million annual rate of the strike-depressed fourth quarter of 1970. According to surveys, however, consumers continued to be concerned about inflation and unemployment. For the most part, therefore, they remained cautious, and the saving rate remained above 8 per cent.

Growth in consumer spending tapered off in the second quarter despite a sizable further rise in disposable income. In real terms such spending increased at an annual rate of about 4 per cent, but this was less than half the rate in the preceding quarter.

8. CONSUMER INCOME, OUTLAYS, AND SAVING



NOTE.—Based on seasonally adjusted annual rates data from BEA, Dept. of Commerce. Income and expenditures are change from preceding quarter. Saving rate is percentage of disposable personal income.

In response to the new economic program, sales of new domestic-type autos, which had leveled off after the first quarter, spurted sharply to an average annual rate of 9.7 million units during the 90-day period, mid-August to mid-November, when the price freeze and the import surcharge were in effect and the proposal to remove the excise tax on autos was being considered. Sales of foreign auto models fell during this period, in part because newly imported autos (subject to the import surcharge) became more expensive relative to domestic cars during the freeze, and later because of limitations on supply as a result of the dock strikes. In late November and in December, after the price freeze had ended, sales of domestic units dropped back to an average rate of 8 million units.

Purchases of durable goods other than autos and of nondurable goods and services rose moderately in the latter half of the year (Table 3), and in real terms increases in total consumer spending continued at about the 4 per cent rate of the second quarter. The saving rate remained above 8 per cent until the fourth quarter when it edged down to about 7.8 per cent as gains in consumption ex-

Table 3: CHANGES IN MAJOR COMPONENTS OF GROSS NATIONAL PRODUCT

In billions of dollars, except for saving rate

Item	1969	1970	1971	1971 [1] I	II	III	IV
Gross national product	**64.9**	**45.0**	**72.7**	**32.4**	**19.2**	**13.4**	**19.5**
Personal consumption expenditures	**43.4**	**36.2**	**46.3**	**20.2**	**12.5**	**11.4**	**8.4**
Durable goods	5.9	−1.3	11.9	11.7	2.5	3.7	.8
Nondurable goods	16.8	17.1	13.9	2.3	4.6	2.4	3.1
Services	20.8	20.4	20.5	6.1	5.5	5.3	4.5
Saving rate (level, in per cent)	*6.0*	*7.9*	*8.2*	*8.1*	*8.6*	*8.1*	*7.8*
Fixed investment	**11.5**	**2.1**	**16.8**	**6.6**	**8.1**	**3.7**	**5.0**
Residential structures	1.1	−1.4	10.2	2.6	4.6	2.7	1.7
Nonresidential	9.8	3.5	6.6	3.9	3.6	1.0	3.3
Inventory change	**.3**	**−4.6**	**−.6**	**−.6**	**1.5**	**−5.8**	**3.6**
Net exports of goods and services	**−.5**	**1.6**	**−3.6**	**2.0**	**−4.6**	**−.1**	**−4.6**
Exports	5.0	7.3	2.4	3.0	.3	1.7	−7.8
Imports	5.5	5.7	6.0	1.0	4.9	1.8	−3.2
Govt. purchases of goods and services	**10.1**	**9.7**	**13.6**	**4.2**	**1.7**	**4.2**	**7.0**
Federal	.4	−2.0	.4	.5	−.4	1.6	2.7
Defense	.1	−3.0	−4.0	−.6	−1.2	−1.2	1.2
Other	.2	1.2	4.3	1.0	.9	2.8	1.5
State and local	9.8	11.6	13.3	3.7	2.0	2.6	4.3

[1] Seasonally adjusted annual rates.
NOTE.—Based on data from BEA, Dept. of Commerce.

ceeded those in income and the increase in consumer instalment debt accelerated.

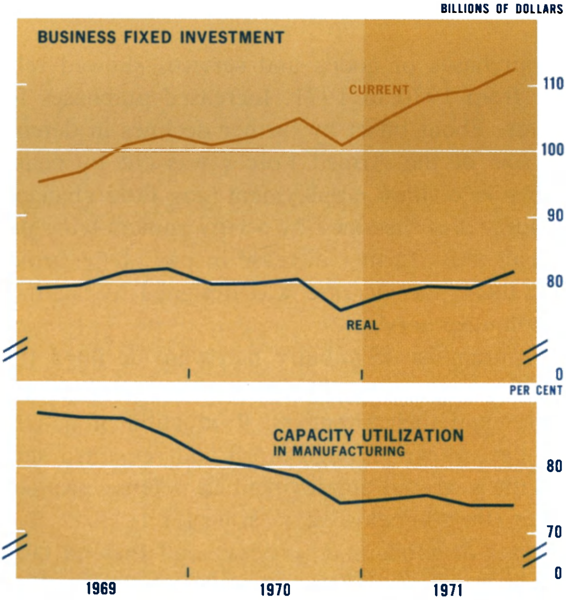
BUSINESS INVESTMENT

The relatively small increases in 1971 in business spending for new plant and equipment and for inventories were among the most important reasons for the sluggish economic growth during much of the year. Business investment in new fixed capital, while increasing by more than 6 per cent in current dollars, showed little change over 1970 in real terms. Businessmen's continued cautiousness in regard to capital investment reflected several factors: the lack of ebullience of consumer and business sales; the continued low rate of manufacturing capacity utilization—less than 75 per cent; and the continuation of before-tax corporate profits at levels significantly below those of 1968–69, although such profits did show a notable improvement through midyear.

Attempts were made to stimulate capital investment early in the year through liberalization of depreciation allowances, but the measures proposed were subject to legal challenges until near the year-end when the allowances, in considerably reduced form, were included in the Revenue Act of 1971. This Act also included a 7 per cent retroactive investment tax credit.

Investment was particularly weak in the manufacturing sector. Declines in spending were pronounced in the primary metals, machinery, and transportation equipment industries; these industries suffered not only from cutbacks in spending for defense and for aerospace but also from sluggish demands generally. Investment was also cut by railroads, where cyclical problems predominated, and by airlines, where seating capacity was well in excess of passenger traffic. Capital spending by electric utilities, communications, and commercial firms, however, remained relatively strong throughout the period.

9. BUSINESS INVESTMENT AND CAPACITY UTILIZATION



NOTE.—Fixed investment: Seasonally adjusted annual rates data from BEA, Dept. of Commerce.

The relatively low rate of inventory investment, which totaled only $2 billion for the year 1971, reflected the relatively high ratio of inventories to sales with which businesses had started the year. In contrast to experience in previous cyclical downturns, total inventories had not been reduced in 1970, and sluggish consumer demand, lack of ebullience in capital spending, and the decline in spending for defense purposes contributed to holding down inventory investment in 1971.

Steel was stockpiled early in the year in anticipation that there might be a strike in the steel industry when labor contracts expired on July 31, but after that date steel stocks were sharply reduced, resulting in an over-all net inventory liquidation during the third quarter. Thus, stock/sales ratios, which had been declining irregularly throughout 1971, ended the year at appreciably lower levels than had prevailed at the beginning. Although inventory investment remained modest in the fourth quarter, the swing from liquidation to accumulation contributed importantly to the acceleration of growth in GNP.

GOVERNMENT

Federal Government purchases of goods and services showed relatively little net change from 1970 to 1971. Increased purchases for nondefense purposes were about offset by further declines in defense outlays. The average size of the Armed Forces was cut by nearly 371,000 from 1970, while civilian employment was little changed. However, Federal spending was sustained by a Government-wide pay increase early in the year and a further increase in pay of the armed services in November; the latter increase was designed to facilitate the building of an all-volunteer service.

On the other hand, purchases of military hardware declined further. The cumulative effects of such cutbacks were severe on the defense products industries and their suppliers. Production of defense and space equipment edged down through April and remained sluggish thereafter, and at the year-end employment in defense products industries was more than 100,000 below year-earlier levels.

In contrast to purchases of goods and services, total Federal Government expenditures rose substantially in the calendar year 1971 (Table 4). Grants-in-aid to State and local governments, which ran

Table 4: FEDERAL GOVERNMENT RECEIPTS AND EXPENDITURES

Federal Sector NIA Accounts

In billions of dollars

Item	Calendar year			1971 [1]			
	1969	1970	1971	I	II	III	IV
Receipts	196.9	191.5	198.7	196.5	197.7	197.8	[2] 202.8
Expenditures	189.5	205.1	221.4	212.7	221.4	224.6	228.7
Purchases of goods and services	99.2	97.2	97.6	96.4	96.0	97.6	100.3
Other	90.3	107.9	124.3	116.3	125.4	127.0	128.4
Surplus or deficit	7.3	−13.6	−23.1	−16.2	−23.7	−26.7	[2] −25.9

[1] Seasonally adjusted annual rates.

[2] Implied in calendar year totals.

NOTE.—Based on data from Dept. of Commerce, BEA. The Federal sector in the national income accounts (NIA) measures Federal receipts and expenditures as they directly affect private incomes in the national accounts. Thus it excludes all Federal lending, which affects private debt but not incomes. Also the timing in some transactions is on an accrual basis; in others, on a delivery basis.

$5 billion more than in 1970, together with higher social security benefits and increases in other transfer payments, boosted Federal Government expenditures by about $17 billion from 1970. At the same time, additional tax reductions enacted during the year—including the auto excise tax reduction and the retroactive investment tax credit—and a slower-than-anticipated rate of economic growth caused increases in receipts to fall short of original expectations. Consequently, the Federal budget deficit (national-income-accounts basis) was $23 billion in calendar year 1971, nearly $10 billion larger than in 1970.

The strong growth trend of recent years in purchases by State and local governments continued in 1971; such purchases rose by over $13 billion, nearly $2 billion more than the increase in 1970. Wages paid by these governments continued to move up at a brisk pace, but the gain in employment was somewhat less than the average for other recent years. This slowing reflected in large part resistance by taxpayers to higher costs and reduced needs for hiring new teachers because of a smaller rise in school enrollments. New Federal legislation subsidizing specific kinds of public service employment in State and local government had only a limited impact, mainly because the program was operational only in the last few months of the year.

Although State and local government borrowing was facilitated by easier conditions in financial markets and lower interest rates, a large portion of the additional funds so obtained were apparently used to strengthen financial positions, and construction expenditures appear to have increased relatively little over the year as a whole.

MANPOWER UTILIZATION

The labor market continued slack in 1971 and unemployment remained relatively high (Table 5). After a year of decline, nonfarm payroll employment began to rise in early 1971, but the gains were small and they were concentrated in the nonindustrial sectors of the economy—particularly in services and in State and local government.

Manufacturing employment, which had fallen sharply throughout 1970, continued to edge down, and prior to the introduction of the new economic program it was 1.8 million below the peak reached in 1969. Employment of both production and nonproduction workers was cut as businesses continued to take measures to limit increases in labor costs. Nor was there any indication at midyear that employers were lengthening the workweek, as was typical of previous recovery periods.

The unemployment rate, which had risen to slightly over 6 per cent at the end of 1970, went no higher in the first half of 1971 because there was little growth in the civilian labor force. Many workers who might normally have sought jobs were discouraged from

Table 5: LABOR MARKET INDICATORS

Changes in thousands of persons, except for unemployment rate, which is rate in final quarter of each year.

Item	Year ending fourth quarter of—		
	1969	1970	1971
Total labor force	2,339	1,330	1,268
Armed Forces	−53	−444	−352
Civilian labor force	2,392	1,774	1,620
Total civilian employment	2,168	−1	1,428
Unemployment rate (per cent)	*3.6*	*5.8*	*5.9*
Nonfarm employment:			
Total	2,033	−719	893
Manufacturing	187	−1,473	−81

NOTE.—Based on BLS data not adjusted for seasonal variation.

Principal Federal Reserve Policy Actions, 1971: Digest

Principal Federal Reserve Policy Actions, 1971: Digest

Period, or announcement date	*Action*	*Purpose*
January 7	Reduced the discount rate from 5½ per cent to 5¼ per cent at 10 Reserve Banks, effective January 8. (By January 15, the 5¼ per cent rate was in effect at all Reserve Banks.)	To bring the discount rate into better alignment with short-term interest rates, which had declined further since the previous reduction in the discount rate was announced on November 30.
January	Directed that System open market operations be conducted with a view to maintaining bank reserves and money market conditions consistent with the objective of promoting accommodative conditions in credit markets and moderate expansion in monetary and credit aggregates.	To foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.
January 15	Amended Regulation M to permit U.S. banks to count toward maintenance of their reserve-free Euro-dollar bases any funds invested by their overseas branches in Export-Import Bank	A further step to temper the adverse impact of Euro-dollar outflows on the U.S. balance of payments.

	securities offered under the program announced on January 15 by the Export-Import Bank. For those banks that have had a minimum (3 per cent of deposits) reserve-free base, postponed for 4 weeks, through the computation period of February 17, 1971, the application of the automatic downward adjustment of their bases.	
January 18	Reduced the discount rate from 5¼ per cent to 5 per cent at 6 Reserve Banks, effective January 19. (By January 29, the 5 per cent rate was in effect at all Reserve Banks.)	To take into account the further declines that had taken place in short-term market rates.
Early February through early April	Directed that System open market operations be conducted with a view to maintaining prevailing money market conditions while accommodating downward movements in long-term rates, with a provision for modification of operations if it appeared that the monetary and credit aggregates were falling short of (after early March, deviating significantly from) the growth paths expected.	To foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation and the attainment of reasonable equilibrium in the country's balance of payments.
February 12	Reduced the discount rate from 5 per cent to 4¾ per cent at 11 Reserve Banks, effective February 13. (By February 19, the 4¾ per cent rate was in effect at all Reserve Banks.)	To accord with the System's recent practice of making small changes in the discount rate to keep it in closer alignment with short-term market rates.

Principal Federal Reserve Policy Actions, 1971: Digest—Continued

Period, or announcement date	*Action*	*Purpose*
April 1	Amended Regulation M to permit U.S. banks to count toward maintenance of their reserve-free Euro-dollar bases any funds invested by their overseas branches in U.S. Treasury securities offered under the program announced on April 1 by the Treasury.	To temper the adverse impact of Euro-dollar outflows on the U.S. balance of payments.
Early April through early May	Directed that System open market operations be conducted with a view to attaining temporarily some minor firming in money market conditions, while continuing to meet some part of reserve needs through purchases of coupon issues in the interest of promoting accommodative conditions in long-term credit markets, with a provision for modification of operations if it appeared that the monetary and credit aggregates were deviating significantly from the growth paths desired.	To foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.
Early May through late August	Directed that System open market operations be conducted with a view to maintaining bank reserves and money market conditions consistent with the objective of achieving more mod-	To foster financial conditions conducive to the resumption of sustainable economic growth, while encouraging an

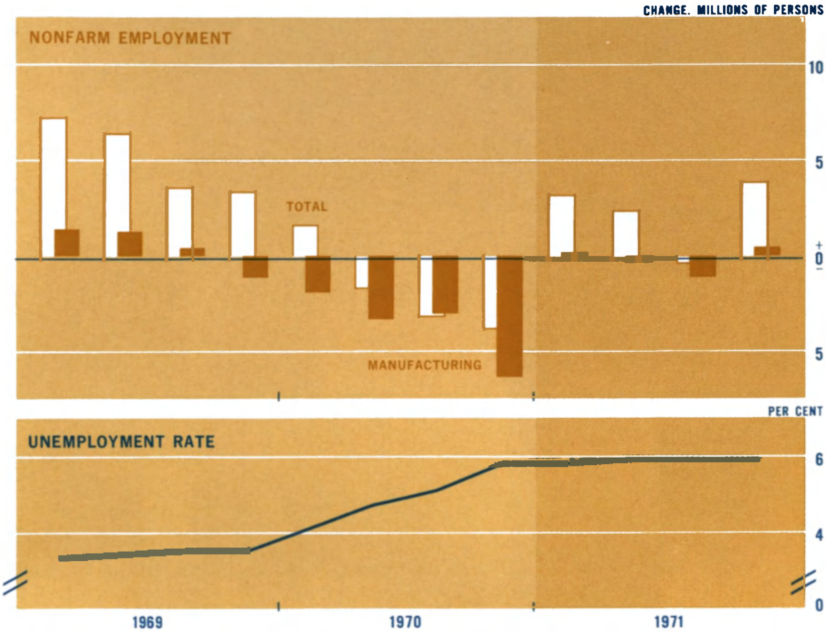
	erate growth in monetary aggregates over the months ahead, while taking account of developments in capital markets.	orderly reduction in the rate of inflation, moderation of short-term capital outflows, and attainment of reasonable equilibrium in the country's balance of payments.
July 15	Raised the discount rate from 4¾ per cent to 5 per cent at 4 Reserve Banks, effective July 16. (By July 23, the 5 per cent rate was in effect at all Reserve Banks.)	To bring the discount rate into better alignment with short-term rates, which had increased, and to reflect the Board's concern over the continuation of substantial cost-push inflation in the economy.
Late August through late September	Directed that System open market operations be conducted with a view to achieving bank reserve and money market conditions consistent with the objective of achieving more moderate growth in monetary and credit aggregates.	To foster financial conditions consistent with the aims of the Government's new economic program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.
August 24	Amended the continuing authority directive with respect to domestic open market operations to authorize outright operations in Federal agency securities.	To widen the base of System open market operations and at the same time add breadth to the market for agency issues.

Principal Federal Reserve Policy Actions, 1971: Digest—Continued

Period, or announcement date	*Action*	*Purpose*
Late September through mid-November	Directed that System open market operations be conducted with a view to achieving bank reserve and money market conditions consistent with the objective of achieving moderate growth in monetary and credit aggregates, taking account (through mid-October) of developments in capital markets.	To foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.
November 10	Reduced the discount rate from 5 per cent to 4¾ per cent at 7 Reserve Banks, effective November 11. (By November 19, the 4¾ per cent rate was in effect at all Reserve Banks.)	To bring the discount rate into better alignment with short-term rates generally, in recognition of the reductions that had taken place in those rates.
Mid-November through mid-December	Directed that System open market operations be conducted with a view to achieving bank reserve and money market conditions consistent with the objective of promoting somewhat	To foster financial conditions consistent with the aims of the new governmental program, including sustainable

	greater growth in monetary and credit aggregates over the months ahead.	real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.
December 3	Reduced the margin requirement for purchasing or carrying stocks from 65 per cent to 55 per cent, effective December 6. Reduced the required deposit on short sales from 65 per cent to 55 per cent, effective December 6.	To be less restrictive in view of the moderate level of outstanding stock market credit and the absence of indications of the excessive use of such credit.
December 10	Reduced the discount rate from 4¾ per cent to 4½ per cent at 4 Reserve Banks, effective December 13. (By December 24, the 4½ per cent rate was in effect at all Reserve Banks.)	To recognize the prevailing levels of market interest rates and to assist the progress of economic expansion.
Mid-December through year-end	Directed that System open market operations be conducted with a view to promoting the degree of ease in bank reserve and money market conditions essential to greater growth in monetary aggregates.	To foster financial conditions consistent with the aims of the new governmental program, including sustainable real economic growth and increased employment, abatement of inflationary pressures, and attainment of reasonable equilibrium in the country's balance of payments.

10. EMPLOYMENT AND UNEMPLOYMENT



NOTE.—Quarterly data, seasonally adjusted, from BLS.

doing so by high unemployment and by the lack of new hiring. At midyear the unemployment rate of white workers was 5.5 per cent, about the same as at the start of the year, but for Negroes and other races combined it had reached a rate of about 10 per cent.

Nonfarm employment, after declining slightly in the third quarter, began to rise again in the closing months of the year, as manufacturing employment stabilized and service-type industries continued to add workers. By the year-end employment in service-type industries had risen by 1.1 million from a year earlier, with both trade and State and local governments showing sizable gains. But as economic prospects improved in the second half, strong increases in total employment were matched by stepped-up growth of the civilian labor force. As a result the unemployment rate continued at about the 6 per cent level. However, an increase in the average workweek after September and a reduction in insured unemployment toward the year-end indicated some strengthening in the labor market. □

Monetary Aggregates and Interest Rates

The money and bank credit aggregates expanded substantially in 1971 (Table 6), while market interest rates receded further from the already reduced levels of late 1970. During the year, however, both interest rates and rates of growth in the aggregates varied over a wide range.

Table 6: SELECTED MONETARY AGGREGATES, 1971

Change, in per cent

Money stock:	
M_1	6.2
M_2	11.1
M_3	13.3
Adjusted credit proxy	9.5
Total reserves	7.3
Nonborrowed reserves	8.1

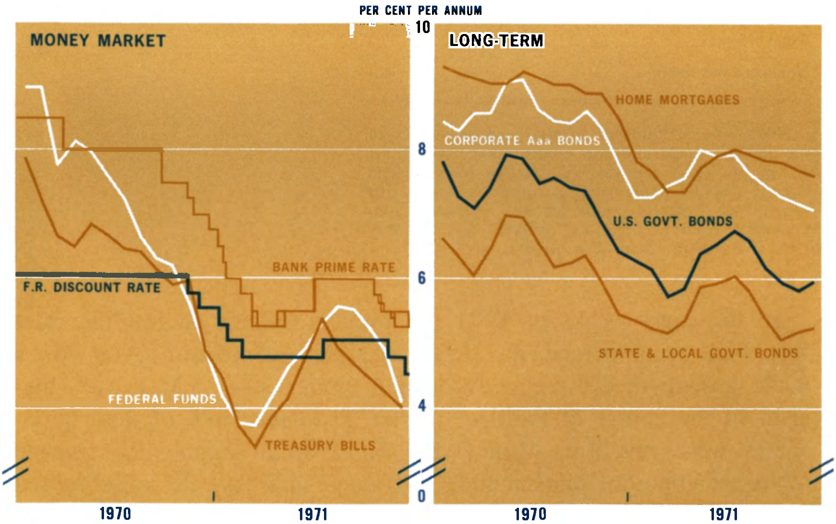
NOTE.—For definitions of the three measures of the money stock and the credit proxy, see Chart 12, p. 34. Total reserves are required reserves held against member bank deposits and nondeposit items subject to reserves, plus excess reserves. Nonborrowed reserves are total reserves less member bank borrowings from F.R. Banks.

In the early weeks of 1971 the cyclical decline in interest rates that had accompanied the 1970 recession continued. And for a while growth of the narrowly defined money stock (M_1) was sluggish. In the course of the first quarter, however, both of these tendencies were reversed. Money and bank credit aggregates showed rapid growth until midsummer, and some interest rates—influenced in part by disappointment as to progress in curbing inflation—rose as much as 200 basis points to levels well above those that had prevailed at the end of 1970.

After the mid-August announcement of the new economic program, inflationary expectations abated and interest rates declined again, reaching year-end levels generally below those that had prevailed at the beginning of the year. At the same time, growth of the money and bank credit aggregates slowed. The deceleration was particularly marked in the narrowly defined money stock, where there had been a sharp build-up in cash balances earlier in the year. For the year as a whole, M_1 grew at an annual rate of 6.2 per cent, somewhat more than in 1970, while M_2 (M_1 plus time and savings deposits other than large negotiable certificates of deposit) and the adjusted bank credit proxy grew by 11 and almost 10 per cent, respectively. Total reserves of member banks rose by over 7 per cent.

Strong demands for credit in 1971 were a factor limiting interest rate declines, particularly in long-term markets. Total funds raised in all credit markets exceeded the previous record, of 1970, by about $50 billion. Borrowing by the Federal Government to finance a record postwar deficit accounted for a sizable part of this increase, but private financing also expanded substantially. New records were set

11. INTEREST RATES



NOTE.—Monthly averages. Yields: U.S. Treasury bills, market yields on 3-month issues; corporate bonds, weighted averages of new publicly offered bonds rated Aaa, Aa, and A by Moody's Investors Service and adjusted to an Aaa basis; U.S. Govt. bonds, market yields adjusted to 10-year constant maturity by U.S. Treasury; State and local govt. bonds (20 issues, mixed quality), Bond Buyer. Home mortgages, FNMA auction; commitments on 3-month maturities until mid-October 1971, and 4-month maturities thereafter.

in mortgage debt expansion; in total financing by nonfinancial corporations, including stocks and bonds; and in borrowing by State and local governments.

Bank and nonbank thrift institutions were of particular importance in supplying the increased volume of funds raised. The generally easy and accommodative stance of Federal Reserve policy contributed to a sharp growth in thrift deposits at these institutions because interest rates in short-term markets remained low relative to those paid on time and savings accounts.

The ample availability of funds at commercial banks encouraged sizable increases in real estate and consumer lending and in loan commitments to business. Takedowns of business loan commitments were quite small, however, as businesses, in lieu of bank credit, continued to rely heavily on capital market financing and as they obtained increased amounts of funds internally through improved profits and rising capital consumption allowances. Banks also channeled a large share of their deposit inflows into security investments, adding in the process to their own liquidity.

At nonbank thrift institutions too, heavy inflows of deposits supported an improvement in liquidity along with a large increase in mortgage lending. In addition, mutual savings banks invested a substantial portion of their deposits in the corporate bond market. A part of the improvement in liquidity reflected large paydowns by the savings and loan associations of advances from the Federal home loan banks. Reduced reliance on the home loan banks and on the Federal National Mortgage Association permitted these institutions, in turn, to reduce substantially their own demands on securities markets.

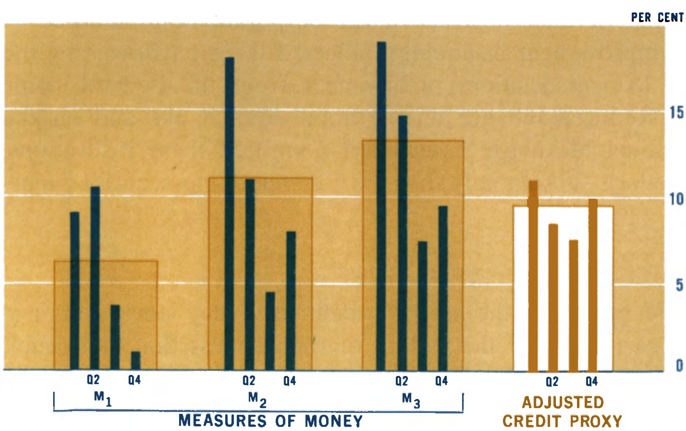
DEVELOPMENTS PRIOR TO AUGUST 15

Early in 1971 growth of the narrowly defined money stock remained quite small, carrying over the pattern of sluggishness that had developed during the auto strike in late 1970. Once the sharp poststrike catch-up in current-dollar GNP was under way, however, growth in the money stock accelerated at a rapid pace. From February through July, M_1 grew at an unusually high annual rate, about 11 per cent.

To a considerable extent this expansion reflected the enlarged need for transactions balances created by the rapid rate of growth in current-dollar GNP during the first half of 1971. In addition, the over-all demand for money in this period appears to have been reinforced by the lagged effects of the sharp decline in short-term interest rates that had started in the summer of 1970 and had carried through the first quarter of 1971. Finally, demands for liquidity may also have been enhanced by prevailing uncertainties about the domestic economic and employment outlook and international financial conditions.

The increased demand for liquidity was also reflected in public acquisition of thrift-type deposits at financial institutions. Such demands were reflected in the two broader measures of the money stock, which grew even faster than M_1 during the first half of 1971. In addition to the general demand for liquidity—and the high rate of consumer saving—the sharp growth in thrift accounts represented a continuation of the expansion in such deposits that had been triggered by the drop in market rates of interest during the latter half of 1970. Since average rates paid on thrift accounts declined only a lit-

12. MONETARY AGGREGATES
Growth in 1971



M_1: Currency held outside the Treasury, F.R. Banks, and the vaults of all commercial banks, plus demand deposits other than interbank and U.S. Government.

M_2: M_1 plus time deposits at commercial banks other than large certificates of deposit.

M_3: M_2 plus deposits of mutual savings banks and savings and loan shares.

Adjusted credit proxy: Total member bank deposits subject to reserves, plus Euro-dollar borrowings, bank-related commercial paper, and certain other nondeposit items.

NOTE.—Quarterly rates of growth derived from daily-average data for last month of the quarter relative to that for last month of preceding quarter.

tle despite the rapid fall in market rates, the relative attractiveness of interest-bearing accounts to savers increased dramatically. Although the process of reintermediation was particularly sharp in the first quarter, both M_2 and M_3 continued to grow faster than M_1 during all of 1971.

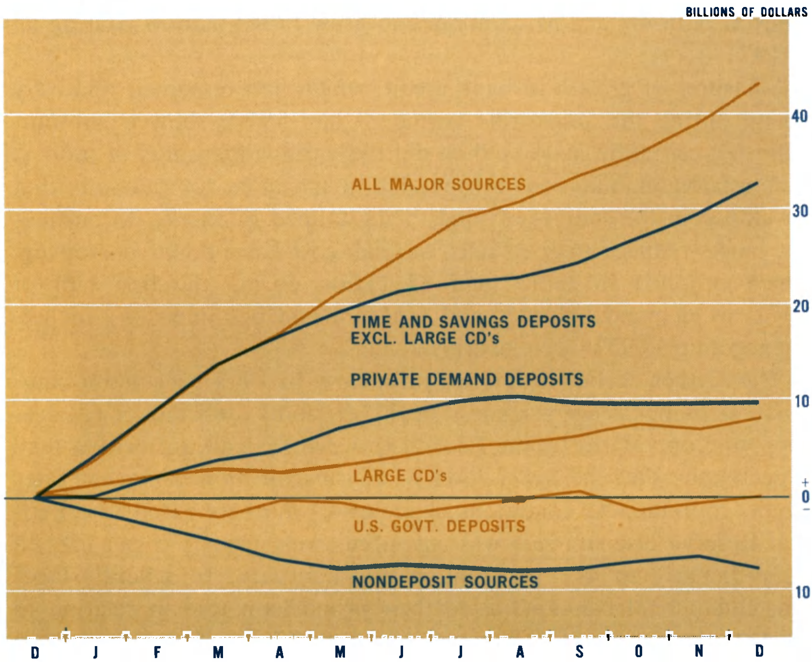
Measures of growth in bank credit, which had remained relatively strong during the auto-strike period of late 1970, showed substantially less variation in 1971 than did the various measures of money. This relative stability was attributable in the main to trade-offs that developed in the sources of funds being tapped by banks. In particular, banks reduced their reliance on high-cost Euro-dollar borrowing, which dropped by more than $7 billion during the first half of 1971, as demand balances and time and savings deposits—including negotiable CD's—rose sharply.[1]

The further decline in interest rates early in 1971 reflected a combination of persistent weakness in the economy, substantial reserve-supplying operations by the Federal Reserve System, and widespread expectations that the lower level of day-to-day money market rates would continue. As conditions in securities markets eased, the Federal Reserve discount rate was cut successively from 5½ per cent in early January to 4¾ per cent in mid-February. In several stages too, commercial banks adjusted their prime loan rate in relation to market rates—from 6¾ per cent in late 1970 to 5¼ per cent in March.

In early February the first of a series of sudden shifts in market expectations led to a marked, but temporary, back-up in long-term market yields. In this case, a combination of influences—including the arrival of somewhat better business news and evidence that the forward calendars of new corporate and municipal debt offerings were expanding—created a market consensus that the cyclical decline in rates had run its course. Because the Treasury was engaged

[1] Some of the reduced borrowing of U.S. banks from their branches reflected the transfer of funds to foreign branches to acquire special Export-Import Bank and U.S. Treasury securities. These special securities were designed to provide an investment outlet for branch Euro-dollar funds in order to reduce incentives to return funds to the Euro-dollar market. Such repayments to the market would have added to dollar holdings of foreign official accounts, complicating the U.S. balance of payments problem. These special issues began in January, reached a high of $3.2 billion in August, and were completely retired by October.

13. BANK FUNDS
Major Sources in 1971



NOTE.—Time and savings deposits other than large certificates of deposit and private demand deposits are for all commercial banks. Time and savings deposits other than large CD's exclude those due to domestic commercial banks and to the U.S. Government as well as balances accumulated for repayment of personal loans. Large CD's are negotiable CD's issued in denominations of $100,000 or more by major commercial banks. U.S. Government deposits and nondeposit sources of funds data are for member banks only.

in a large debt refinancing and a pre-refunding at the time, the market was especially sensitive. Later, when it became apparent that money market conditions were continuing to ease and that the basic strength of the economy was subject to question—once allowance had been made for the auto-strike catch-up—long-term rates declined again, notwithstanding the heavy volume of capital market financing. This further decline was abetted by large Federal Reserve purchases of longer-maturity Treasury securities.

After mid-March, however, both short- and long-term rates began a sustained uptrend that extended to midsummer and again raised rates generally to levels above those of late 1970. A number of factors contributed to this over-all advance. One was the stronger-than-anticipated demands for borrowing; in particular, capital market financing by businesses and State and local governments became larger and more sustained than had earlier seemed likely. At the same time U.S. Treasury borrowing remained large, and estimates of the volume of financing to be undertaken by the U.S. Government in the second half of the year expanded as the year progressed.

During the spring of 1971 the Federal Reserve, in an effort to slow the continued rapid growth of the monetary aggregates, began to supply reserves less aggressively and thus contributed to a tightening of money market conditions. The accelerated rate of growth in the monetary aggregates in the first quarter offset the relatively sluggish growth of the preceding quarter and supported the poststrike catch-up in current-dollar GNP. But persistence of such rapid growth rates into the spring raised questions in the minds of some observers as to the prospects both for success in controlling domestic inflation and for the future course of monetary policy.

Over the second quarter, the gradual tightening of money market conditions tended to accentuate the upward pressures on interest rates being exerted by other factors. In an effort to promote accommodative conditions in longer-term markets, the System supplied reserves to the extent feasible through purchases of Treasury issues maturing in more than a year.

Market rates, particularly short-term rates, were also influencing, and were being influenced by, international flows of liquid or speculative funds during this period. The marked further widening of spreads between U.S. and foreign interest rates that had developed in early 1971 appeared to be encouraging an increase in capital outflows over and above the large repayments of Euro-dollar borrowing by major banks. With deterioration of the trade balance also contributing to a marked over-all worsening in the U.S. balance of payments, large dollar outflows in anticipation of possible adjustments in exchange rates began to develop during April. Although these outflows subsided temporarily after several key European currencies were allowed to float or were revalued upward in May, uncertainties about the international monetary outlook persisted.

Around midyear the pace of the general advance in interest rates seemed about to quicken. At that time deepening concern about the state of the U.S. trade balance appeared to be threatening a resurgence of speculative dollar outflows on an even larger scale than in April. This trend, together with the continued active expansion of the monetary aggregates and growing frustrations about the stubborn persistence of wage and price pressures, seemed to presage an immediate further firming of money market conditions.

This market expectation was strengthened by an increase in the discount rate in July by ¼ of a percentage point to 5 per cent. With the period of heavy deficit financing by the Treasury just getting under way, and with long-term rates remaining high in an environment marked by disappointment about the progress being made to curb inflation under prevailing policies, further general rate increases were beginning to seem inevitable.

LATER DEVELOPMENTS

Once the President had announced his new economic policies, however, interest rates reversed course. The ensuing downtrend reflected, in large part, the diminution of inflationary expectations resulting from the institution of wage-price controls. This, together with the new measures to improve the balance of payments and the functioning of international exchange markets, also led market participants to modify their earlier view that monetary policy would have to seek more restrictive money market conditions.

Treasury bill yields had declined somewhat even before the President's new policies were announced, and after the announcement they dropped faster than other market rates of interest. The decline in bill yields in July reflected the relative ease with which the Treasury had met its first large financing needs of the new fiscal year. Purchases of Treasury bills by foreign official accounts contributed to the easing of conditions in the bill market after midyear as foreign official institutions were acquiring dollars in support of their own currencies as speculation against the dollar mounted.

Dollar outflows continued at a high rate following the general floating of exchange rates in mid-August, and foreign official demand for U.S. Government securities remained strong. At the same time, the supply of new bill offerings in the market was substantially less than had previously been anticipated because acquisitions of special issues by foreign central banks had reduced the need for other Treasury borrowing. Altogether, foreign and Federal Reserve acquisitions of Treasury debt during the third quarter totaled about $12 billion; this compared with Federal net cash borrowing of about $9 billion during the period.

Other market rates of interest also fell after the President's announcement. By the end of October short-term yields—other than those on bills—had declined by 50 to 75 basis points from their levels in mid-August, 90-day bills were off 90 basis points, 1-year bills had fallen 140 basis points, and some long-term yields were lower by about a full percentage point. The bank prime rate, which had been raised in two steps from 5¼ per cent in March to 6 per cent in July, began to decline in October. In that month a few large banks announced that they would henceforth follow a more flexible prime-rate policy—adjusting their quoted rates automatically to changes in short-term market rates of interest. While most banks continued to set their prime rate administratively, the prime rate did decline in a series of frequent, small changes from 6 per cent in July to 5¼ by the year-end.

The general decline in market rates of interest that had begun in August was temporarily interrupted in November by congestion in the securities market that was associated with uncertainties about Phase II of the President's program and the apparent stalemate in international monetary negotiations at the time of a large Treasury refinancing and pre-refunding. By early December, however, market sentiment had improved and sizable Federal Reserve purchases of Treasury coupon issues greatly reduced dealers' excess inventories.

In November and December the discount rate was lowered in two stages from 5 to 4½ per cent and around the turn of the year both short- and long-term interest rates dropped sharply further as the Federal Reserve System moved in a more aggressive way to supply reserves and as liquidation of short-term Treasury debt by foreign central banks failed to materialize in the volume anticipated. By late January 1972, the bank prime rate had been cut further to a general level of 4¾ per cent, and at a few large banks to 4½ per cent—in the latter case, the level for the period 1960 through late 1965.

Although interest rates declined following the President's mid-August change in economic policy, growth in M_1 slowed appreciably.

The initial phase of the slowdown appeared to be associated with the increased outflow of dollars during August. Speculators and hedgers had sought to profit from, or protect themselves against, the expected rise in value of foreign currencies relative to the dollar. Some domestic holdings of dollar balances were drawn down in the process, but the bulk of the outflow was probably financed in other ways. For example, both domestic and foreign demands for loans at U.S. banks increased sharply in August, and the proceeds of many of these loans were used to prepay liabilities in foreign currencies or to acquire foreign currencies for future payment or to profit from future revaluations.

The public's demand for money in the late summer and early fall remained lower relative to income than it had been in preceding months. In this period the public may have shifted out of cash balances built up earlier for precautionary reasons and into market securities in an effort to capture peak yields, in view of the widespread expectations that the new economic program would lead to lower interest rates. In addition, improved public confidence in both the domestic and the international economic outlook probably reduced the demand for liquidity. Finally, the increases in interest rates during the spring and early summer had made it cost more to hold money, and this earlier rise in rates continued into the fall to affect the demand for money.

By the third quarter the higher level of interest rates had already contributed to a significant slowing of the growth in consumer-type time and savings deposits at banks, despite a reversal of the scattered rate cuts that had been instituted at a number of major institutions in the spring. Inflows also had slowed at nonbank thrift institutions —but to a lesser degree inasmuch as these institutions still paid higher rates on deposits than banks did and fewer of them had reduced offering rates in the spring. With savings inflows thus more moderate, growth of M_2 and M_3 decelerated, although not so sharply as M_1.

Growth in bank credit—as measured by the adjusted credit proxy —did not fall off nearly so much in the third quarter as the money stock aggregates. Cutbacks in the expansion of private demand and consumer-type time deposits at banks were generally offset by an expansion in large negotiable CD's (many of which were taken by foreign accounts), by increases in U.S. Government deposits (arising from the large foreign official purchases of special Treasury certificates), and by a virtual cessation of U.S. bank repayments of Euro-dollar borrowings to their foreign branches.

Similarly, in the fourth quarter, even though M_1 expanded at an annual rate of only 1 per cent, the credit proxy rose at close to a 10 per cent annual rate, or a little faster than in the third quarter. This fourth-quarter expansion reflected a sharp acceleration in time and savings deposits other than CD's to a 15 per cent annual rate; as a result M_2 in this period accelerated to an 8 per cent rate of growth, despite the slow growth in M_1.

Over 1971 as a whole, the monetary aggregates expanded substantially. While growth in M_1 was sluggish in the latter part of the year, it had been very rapid earlier in the period. Broader measures of the money stock grew considerably faster than M_1 and contributed to greater public liquidity, while credit from banks and other financial institutions remained ample throughout the year. By the year-end most interest rates were at or near their lows for the year. Rates in short-term markets had declined quite sharply as monetary policy was directed toward promoting the degree of ease in bank reserves that would lead the monetary aggregates to grow at a rate sufficient to support accelerated economic recovery. □

Total Credit Flows and the Financing of Private Investment

The net flow of credit through domestic markets was at an unprecedented rate in 1971, both in dollar amounts and in relation to economic activity. Net funds reached a total of $151 billion, about 50 per cent more than in any previous year. The total was 14 per cent of GNP, well above the 1968 high of 11 per cent and the 10 per cent average for the 1960's.

This record volume of credit consisted mainly of a combination of heavy Federal borrowing to cover the year's deficit, a volume of private financing that was large relative to capital outlays, and State and local government borrowing well in excess of fiscal needs. Foreign borrowing in U.S. markets was also sharply higher than in 1970 and earlier years, but it remained a small part of the total.

SOURCES OF CREDIT SUPPLY

The financing of such large credit flows was accomplished with market interest rates declining somewhat over the year, although sizable fluctuations in such rates occurred during the year. Rates in short-term markets were unusually low relative to long-term rates—such as those for mortgages and corporate bonds—and savings institutions that lend predominantly in long-term markets offered yields on deposits that were very attractive relative to money market rates. In view of this rate advantage, time and savings deposits grew by an unprecedented 17 per cent in 1971, and these institutions were a dominant source of funds to credit markets.

An important element in short-term markets and in the forms of credit flow in 1971 was the very large volume of U.S. Government securities purchased by foreign official reserve holders; sizable acquisitions of Treasury bills by foreign central banks accounted in part for the decline in the Treasury bill rate relative to other market rates. During the year these institutions bought $27 billion of U.S.

Government securities, more than total Treasury borrowing; over the same period domestic private holdings of Treasury issues decreased. In the absence of these outflows, private investment in U.S. markets would have been larger and foreign official acquisitions of U.S. Treasury securities smaller.

Purchases by foreign official accounts were the counterpart of the weak current-account position in the U.S. balance of payments and the large volume of private capital outflows. The capital outflows took a variety of forms, such as bank repayment of foreign borrowings, loans to foreign borrowers, and liquidation of dollar assets held by private foreigners. Some of the borrowing, both foreign and domestic, shown in Table 7 reflects the strong demand for foreign exchange, but there is a great deal of uncertainty as to the form of much of the outflow.

The relation of foreign inflows to U.S. credit markets is indicated in Table 8, where the sharp increase from 1970 in U.S. Government borrowing is more than offset by larger foreign purchases. Private domestic lending in credit markets increased less sharply than total borrowing, and all of the domestic credit supply was in the form of private loans and securities.

Although private domestic lending increased less, proportionately, than total borrowing from 1970 (Table 8), the $112 billion flow from the private sector was sharply higher in relation to activity and income than in any other year of the preceding two decades. Moreover, the flow originated entirely in banks and nonbank financial in-

Table 7: FUNDS RAISED IN CREDIT MARKETS BY NONFINANCIAL SECTORS

Sector	Amount: In billions of dollars, 1970	Amount: In billions of dollars, 1971	Amount: Percentage change, 1970 to 1971	Percentage of GNP: 1966–70 avg.	Percentage of GNP: 1971
Total [1]	97.5	151.1	55.0	10.1	14.4
U.S. Government	12.8	25.5	99.2	.9	2.4
State and local governments	12.2	18.7	53.3	1.1	1.8
Foreign	2.6	5.4	107.6	.3	.5
Households and nonfinancial business [1]	69.9	101.5	45.2	7.8	9.7

[1] Includes net issues of corporate equities.

Table 8: TOTAL FUNDS RAISED AND PRIVATE DOMESTIC CREDIT SUPPLY

Sector, or supplier	Amount (in billions of dollars)			Percentage change, 1970 to 1971
	1969	1970	1971	
A. Funds raised in credit markets by nonfinancial sectors	**90.4**	**97.5**	**151.1**	**55.0**
B. U.S. Government	−3.6	12.8	25.5	99.2
C. Other [1]	93.9	84.7	125.6	48.3
Funds supplied directly, by:				
D. Foreign	1.3	10.9	28.4	160.6
E. Public agencies, net [2]	6.9	9.4	11.0	17.0
F. Private domestic lenders (A−D−E)	**82.2**	**77.2**	**111.7**	**44.7**
G. To: U.S. Government	4.6	5.8	−6.0	−203.4
H. Other	77.6	71.4	117.7	64.8
I. By: Commercial banks	12.2	31.3	47.5	51.8
J. Savings institutions	10.4	14.7	40.8	177.6
K. Other finance	19.7	24.2	27.9	15.3
L. Nonfinancial investors [3]	39.8	7.1	−4.5	−163.4

[1] Includes corporate equities.
[2] U.S. Government, federally sponsored credit agencies, and Federal Reserve System. Net of security issues by sponsored agencies.
[3] Households, nonfinancial business, and State and local governments.

stitutions; nonfinancial investors liquidated holdings of credit market instruments, net, over the year. The extent to which the domestic credit supply was intermediated was as unprecedented as the size of the flow for a period as long as a year, and it indicated the yield advantage of deposits over money market instruments as liquidity holdings during the period.

As indicated earlier in this report, the flow into time and savings accounts supplied an unusually large volume of funds to lenders who specialize in mortgage credit. Thus, it provided a strong financial base for the high and rising rate of housing construction, which continued through the year, and also for some forms of business investment. Savings institutions were the source of 60 per cent of total mortgage funds supplied in 1971, a higher proportion than in the 1961–65 period of rapid deposit growth, and mutual savings banks also bought one-fifth of the net new corporate bond issues, and savings and loan associations repaid borrowings from the Federal home loan banks. Commercial banks were also substantial lenders in mortgage markets, with loans on real estate absorbing a fourth of total bank credit flows.

PRIVATE DOMESTIC FINANCING

Funds raised by households and nonfinancial business in credit and equity markets were far larger than would have been expected, based on past relationships to private saving or capital investment. Both net residential mortgage financing and business credit flows were up sharply from recent years in relation to capital spending (Table 9), and the ratios for both types of financing were well above those for any other year of either the 1950's or the 1960's. During the 1960's total external financing by households and business had stayed within a fairly narrow range of 31 to 34 per cent of total capital outlays on an annual basis, in spite of wide variations in credit conditions and in the relation between saving and capital spending. The 41 per cent relationship in 1971 is a sharp departure from this experience.

The upward pace of residential mortgage flows in 1971 accompanied a sharp upsurge in outlays for construction of both single-family and multifamily housing units. However, not all of the increase in net flows of such credit reflected new lending to finance the record

Table 9: EXTERNAL FINANCING BY HOUSEHOLDS AND NONFINANCIAL BUSINESS

Item	Amount (in billions of dollars)			Percentage change, 1970 to 1971
	1966–70 avg.	1970	1971	
NET FUNDS RAISED:				
A. Residential mortgages	17.5	18.7	33.8	80.7
B. Percentage of residential construction	*61*	*62*	*83*	
C. Corporate equities [1]	2.7	6.8	13.5	98.5
D. Corporate bonds [1]	14.0	20.3	18.3	−9.9
E. Business loans and nonresidential mortgages	20.7	14.9	19.6	31.5
F. Total nonresidential business	**37.4**	**42.0**	**51.4**	**22.4**
G. Percentage of nonresidential business capital expenditure	*40*	*43*	*50*	
H. Other external financing [2]	12.5	9.2	16.4	78.3
I. Total external financing	**67.4**	**69.9**	**101.5**	**45.2**
J. Percentage of total capital outlays [3]	*33*	*32*	*41*	
CAPITAL OUTLAYS:				
K. Residential construction	28.5	30.4	40.6	33.6
L. Nonresidential business plant and equipment outlays and net inventory change	92.7	97.6	103.1	5.6
M. Consumer durable goods and nonprofit-institution plant and equipment	86.1	93.9	105.8	12.7
N. **Total**	**207.3**	**221.9**	**249.5**	**12.4**

[1] Nonfinancial corporations only.
[2] Consumer credit, policy loans, and borrowing by nonprofit institutions.
[3] Capital outlays include those for consumer durable goods and nonprofit-institution plant and equipment.

pace of construction. Much of it derived from borrowing on existing houses, following an extended period in 1969 and 1970 when transactions in older houses were particularly difficult to finance because of the limited availability and exceptionally high cost of mortgage credit.

The increase in business financing was dominated by corporate equities, which supplied almost one-fourth of net new funds for nonfinancial business. Beginning in 1966, the gross flow of new equity capital had risen steadily and rapidly from a $3 billion annual rate in the first half of the 1960's to $13.5 billion in 1971; the growth in such offerings not only compensated to some extent for the relative decrease in retained earnings as a source of corporate funds but also helped to slow the growth in debt ratios. Through some of this period the growth of new offerings was offset by sizable retirements of equities in mergers. But more recently these retirements have fallen off sharply—from a 1968 rate of $7 billion to less than $1 billion in 1971—and net equity funds available to business have risen even more sharply than gross offerings. As in recent years, most of the net funds supplied to corporations through equities in 1971 came from pension funds and life insurance companies, which together increased their purchases over the 1970 total by almost as much as the rise in net issues.

Net new bond issues were close to the very high rate established in 1970—reflecting the continued strong demand by corporations for long-term credit even though interest rates on bonds remained relatively high. One-fifth of this net flow represented purchases by mutual savings banks; life insurance companies increased their net buying sharply, but purchases by individuals were significantly reduced from the very high 1970 levels. Commercial mortgages, another form of long-term credit, increased from a net flow of $5 billion in 1970 to $9 billion in 1971; almost all of the increase represented loans from commercial banks and savings institutions.

The net amount of new long-term financing through equities, bonds, and commercial mortgages accounted for a dominant part—80 per cent—of the total funds raised by business in 1971. These long-term funds reduced sharply the importance of short-term credit in business debt structures and brought short-term debt ratios back to their pre-1969–70 levels. Business loans at banks grew moderately during 1971—except in the third quarter when international devel-

Table 10: PRIVATE DOMESTIC SAVING AND INVESTMENT

Item	Amount: In billions of dollars, 1970	Amount: In billions of dollars, 1971	Percentage change, 1970 to 1971	Relative to GNP: Per cent, 1966–70 avg.	Relative to GNP: Per cent, 1971	Change (percentage points), 1966–70 avg. to 1971
Households and nonfinancial business:						
A. Gross saving	245.5	276.4	12.6	25.5	26.4	.9
B. Capital expenditures	222.0	249.5	12.4	24.1	23.8	−.3
C. *Less:* External financing	69.9	101.5	45.2	7.8	9.7	1.9
D. *Equals:* Internal financing (B−C)	152.1	148.0	−2.7	16.3	14.1	−2.2
E. Net financial uses of funds (A−D)	93.4	128.4	37.5	9.2	12.3	3.1
State and local governments:						
F. Net current surplus	−6.0	−4.0	−33.3	−.5	−.3	.2
G. External financing	12.2	18.7	53.3	1.1	1.8	.7
H. Net financial uses of funds (F+G)	6.2	14.7	137.1	.5	1.4	.9
Private financial investment:						
I. Total net financial uses of funds (E+H)	**99.6**	**143.1**	**43.7**	**9.7**	**13.6**	**3.9**
J. Currency and deposits	61.1	93.0	52.2	4.4	8.9	4.5
K. Credit market instruments	7.1	−4.5	−163.4	1.8	−.4	−2.2
L. Other, net	31.4	54.6	73.9	3.5	5.2	1.7

opments generated a temporary surge in loans. There was very little growth in commercial paper or in loans from nonbank financial institutions.

SAVING AND INVESTMENT

The high rates of external financing by households and business in 1971 relative to capital outlays were matched, for the group as a whole, by comparably large flows into financial assets. Private saving increased by a somewhat larger amount than capital expenditures from 1970, but each continued to have approximately the same relation to GNP as the average for 1966–70 (Table 10). Because the increase in external financing was larger in absolute amount than the increase in outlays, financial uses of funds rose to an unprecedented 46 per cent of gross private saving, as compared with an average of 36 per cent for 1966–70.

State and local government financing was also very large in 1971 relative to the total need for funds. Municipal borrowing had picked up sharply after mid-1970, when commercial banks increased their purchases of tax-exempt securities, and by the end of 1970 the liquidity of State and local governments had recovered from a low position at the beginning of the year to a level that was more normal in relation to expenditures. Early in 1971, however, net issues of municipal securities increased even further. Banks were able to absorb most of the increase in offerings during the year, and there was little incremental buying of such securities by nonfinancial investors.

With households, businesses, and State and local governments all active during the year both as borrowers and as lenders, their total financial uses of funds increased sharply from 1970 in dollar amount and to a new high level in relation to GNP. Of total financial uses, the flow into money, time deposits, and savings accounts was about 65 per cent—a higher proportion than for 1970 and also above the 1961–65 average, when institutional flows were also a large component of total credit flows.

Direct purchases of credit market instruments by private domestic investors were negative in 1971, as was mentioned earlier. "Other" financial uses of funds, however, were extremely large. These "other" uses are to some extent unidentified in the statistics, and they probably include part of the private capital outflows to foreign countries, both recorded and unrecorded, which rose to such large proportions in 1971. Capital outflows were an important counterpart of foreign official purchases of Treasury securities during the year.

LIQUID ASSETS

The total liquid asset position of the domestic private nonfinancial economy increased slightly during 1971 as a result of the unusual size and structure of flows. On the basis of a simple measure of liquid assets—holdings of money, time and savings accounts, U.S. Treasury and agency securities, and commercial paper—the 1971 year-end total was slightly more than 83 per cent of GNP (Table 11). This represents a departure from a narrow range of 82 to 83 per cent of GNP, a level that has been maintained for well over a decade, except in the two tight-credit periods of 1966 and 1969.

The deposit component of liquid assets rose sharply as a result of institutional flows in 1971 and reached a level well above preceding peaks. This rise was partly offset, however, by the decrease in holdings of Government securities and of commercial paper.

Table 11: PRIVATE LIQUID ASSET HOLDINGS

End-of-year figures as a percentage of fourth-quarter GNP, seasonally adjusted annual rate

Year	Total	Currency and deposits	U.S. Govt. securities [1]	Commercial paper
1959	82.0	59.7	22.1	.2
1965	82.8	66.3	15.6	.9
1966	80.6	64.0	15.5	1.1
1967	82.5	66.9	14.4	1.2
1968	82.4	66.7	14.1	1.6
1969	80.4	63.2	14.8	2.4
1970	82.5	66.8	13.5	2.1
1971	83.3	70.2	11.2	2.0

[1] Includes Federal agency issues.

This measure of liquid assets probably understates to some extent the 1971 position of private holders. As mentioned earlier, "other" financial uses of funds by this group undoubtedly included part of the unrecorded private capital flows that occurred in 1971. Insofar as those funds were placed abroad in liquid forms for higher yields and/or to await readjustments in exchange rates, they are statistically a missing component of private liquidity; they will appear in the totals whenever they are returned to U.S. markets.

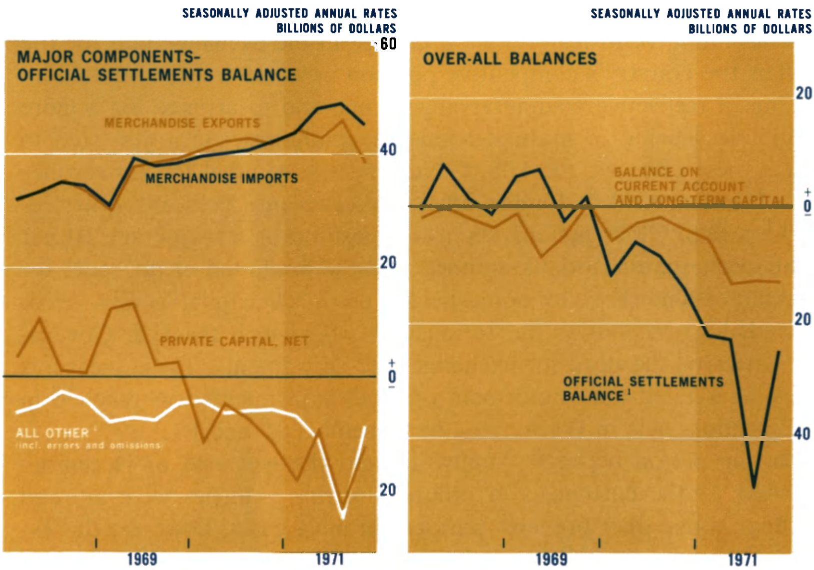
If allowance is made for unknown assets held abroad, it is probable that the large scale of private borrowing and lending during 1971 was sufficient to lift liquidity holdings of the nonfinancial economy even further out of the narrow range of recent years. The heavy emphasis by business on long-term financing also reduced sharply the position of short-term debt in business capital structures. Both of these developments have put the private economy in a favorable position for further growth of activity. □

U.S. Balance of Payments

During 1971 it became evident that the balances of both current and capital transactions between the United States and the rest of the world had worsened to such an extent that conventional changes in monetary or fiscal policies here or abroad could not be expected to reverse the trend. In fact, the cyclical situation was adverse for the balance of payments because demand in the United States was strengthening whereas in most major foreign countries—where resource utilization was still relatively high—the pace of economic advance was slowing.

The international monetary scene in the first half of the year was dominated by huge flows of funds to Germany, as that country continued to pursue a relatively tight monetary policy, while the revaluation of the mark in 1969 did not appear to have diminished Germany's strong trade surplus. By April these flows reflected market expectations that the mark would be revalued, and on May 10 the German authorities allowed the mark to float; at the same time the

14. U.S. BALANCE OF PAYMENTS



[1] Excludes SDR allocations.

Netherlands guilder was allowed to float and Switzerland and Austria revalued their currencies.

For a brief period thereafter there was a partial reversal of speculative flows and some relaxation of tensions in international markets, but as evidence of the deepening troubles of the U.S. balance of payments mounted, another and much more massive flow of funds got under way. Demands for the currencies of most other industrial countries built up, and foreign official reserve accruals accelerated. By the end of July U.S. liabilities to foreign official accounts stood at $37 billion, compared with $24 billion at the end of 1970; meanwhile, U.S. reserve assets had fallen from $14.5 billion to $13.3 billion. In the first 2 weeks of August reserve liabilities grew by about $4.5 billion, while reserve assets were reduced by $1.2 billion. Reductions in reserves occurred mainly in connection with repayments by other countries to the International Monetary Fund. Moreover, the United States made large drawings on swap lines with some countries that were accumulating large holdings of liquid dollar assets.

MEASURES OF AUGUST 15

The external measures announced on August 15 as part of the new economic program represented an effort by the United States to exercise an initiative to restore, via a change in the exchange rate for the dollar, the country's competitive position in world trade, to obtain an easing of restrictive trading arrangements, and to arrange for a more equitable sharing of mutual defense expenditures. As a first step to effect these changes, the U.S. Government suspended the convertibility of dollars held in foreign official reserves into gold and other reserve assets. Other actions taken—imposition of a temporary 10 per cent surcharge on dutiable imports and the limitation of tax relief for capital expenditures to domestically produced capital goods—were intended to emphasize the seriousness with which the U.S. Government viewed the need for exchange rate adjustments. These measures were eliminated once agreement on such adjustments was reached in the meetings held in Washington on December 17 and 18.

In the period between August 15 and the weekend of December 17 and 18 the currencies of other industrial countries were allowed to float above their previous parities. In most cases, however, the extent of the appreciations of these currencies was limited by official intervention in the market or by various measures intended to limit inflows of speculative and interest-sensitive funds. In that period the outflow of funds from the United States (reflecting not only flows of liquid funds but also leads and lags in payments of all kinds) was again very great, and liabilities to foreign official accounts rose by almost $12 billion. Japan was the principal recipient, as that country was reluctant to accept at an early stage the major revaluation that was generally expected.

As negotiations toward a realignment of exchange rates proceeded, the extent of the change in the U.S. balance of payments that was required came to be better understood, though it was actively debated. In particular, the U.S. trade balance had clearly tended to deteriorate more rapidly in recent years than could be accounted for by changes in general demand conditions here and abroad. By 1972 the trade balance could be expected to register a deficit substantially larger than that already in prospect for 1971. It also seemed clear that, in the absence of major adjustments of exchange rates, the balance on current and long-term capital transactions would be headed for a deficit even larger than in 1971, whereas a surplus of some size for these transactions would be necessary to produce a satisfactory balance on official settlements.

MERCHANDISE TRADE

The U.S. trade balance in 1971 dropped to a deficit of nearly $3 billion compared with a surplus of $2 billion in 1970 (Table 12). The trade deficit stemmed from a very weak showing in exports, which were only slightly higher in value than in 1970, while imports advanced sharply—by about 15 per cent. Part of the difference reflected a somewhat larger increase in import prices than in export prices.

On the export side, increases in sales of agricultural commodities, in sales of automotive vehicles and parts to Canada, and in deliveries of commercial aircraft were just about offset by declines in shipments of machinery and industrial materials. The declines in these exports were attributable mainly to the easing of demand in foreign industrial countries. In volume terms, exports as a whole were slightly lower in 1971 than in the previous year.

The gains in imports in 1971 were broadly based, with all major

Table 12: U.S. INTERNATIONAL TRANSACTIONS

In billions of dollars, seasonally adjusted

Item	1970	1971 p	1971 I	1971 II	1971 III	1971 IV p
Merchandise trade balance	2.1	−2.9	.3	−1.1	−.6	−1.5
Exports	42.0	42.8	11.0	10.7	11.5	9.6
Imports	39.9	45.7	10.8	11.8	12.0	11.1
Services, remittances, pensions, net	.1	1.4	.6	.7	.2	−.1
U.S. Govt. grants and credits, net	−3.8	−4.2	−1.1	−1.1	−1.1	−1.0
Long-term private capital, net	−1.5	−5.1	−1.0	−1.8	−1.7	−.5
Balance on current account and long-term capital	−3.0	−10.9	−1.3	−3.2	−3.2	−3.2
Nonliquid short-term private capital	−.5	−2.8	−.4	−.4	−1.2	−.9
Errors and omissions	−1.1	−9.3	−1.0	−2.3	−5.1	−.8
Liquid private capital	−6.0	−7.2	−3.0	.1	−2.8	−1.5
Of which: Liabilities to foreign commercial banks	−6.5	−6.6	−3.1	−.1	−2.1	−1.3
Official settlements balance [1]	−10.7	−30.3	−5.7	−5.9	−12.3	−6.4

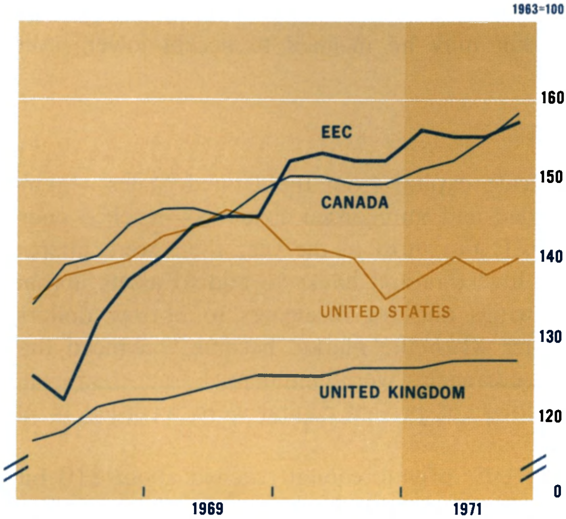
p Fourth-quarter data are partly estimated.
[1] Excludes SDR allocations.
NOTE.—Dept. of Commerce data, with some Federal Reserve estimates. Details may not add to totals because of rounding.

categories of goods—foods, industrial materials, capital equipment, automobiles, and other consumer goods—increasing over 1970 levels. The greatest increase was in imports of autos, especially from Japan. Despite this increase, sales of imported autos other than those from Canada accounted for about the same share of total U.S. sales of autos as they had in 1970—about 15 per cent of the number of vehicles— but this was a much higher share than the 10 per cent average for 1967–69.

A rise in prices of foreign goods accounted for about one-third of the increase in the value of imports in 1971, whereas in 1970 nearly two-thirds of the increase in imports had stemmed from price increases—as measured by unit values.

Trade movements in 1971 were greatly affected at times by such factors as actual or anticipated domestic strikes (mainly in port operations, steel, aluminum, and coal), anticipation that "voluntary" controls would be imposed by foreign governments on their industries' sales to the United States, and the increasing possibility of changes in currency values. Therefore it is difficult to determine how

15. INDUSTRIAL PRODUCTION



NOTE.—Seasonally adjusted quarterly data from the Organization for Economic Cooperation and Development. Data for fourth quarter of 1971 partly estimated.

much of the 1971 deterioration in the U.S. trade position resulted from these factors rather than from more enduring ones. In addition, the deceleration in business activity abroad and the easing of supply conditions in Europe and Japan were major causes for the downturn in U.S. exports of machinery and industrial materials—and probably also for the rise in imports, as foreign producers intensified their selling efforts in the United States. At the same time, however, continued sluggishness in domestic economic activity held imports to levels below what they would have been if output and consumption here had been more buoyant.

The steady deterioration in the trade balance of recent years is expected to be slowed or arrested in 1972 as the recently announced changes in exchange rates begin to shift competitive advantages. However, it may take 2 or 3 years before rearrangements of production and consumption patterns both here and abroad will have gone far enough to produce substantial improvement. In the short run, the U.S. trade balance is likely to be affected mainly by general business conditions, as economic activity in the United States gains momentum while foreign economic activity may remain below optimal levels. Under such conditions, foreign demand for U.S. products will be blunted, even at relatively favorable prices, while foreign suppliers to the U.S. market may be inclined to accept lower profit margins.

CAPITAL FLOWS

The net outflow of private capital from the United States—taking into account both recorded and unrecorded elements—reached enormous proportions in 1971. For most of the year there were interest rate incentives for U.S. investors and banks to add to assets abroad or repay foreign borrowings and for foreigners to borrow dollars. Outflows spurted at times when the market became convinced that appreciations of foreign currencies were imminent. Larger-than-usual outflows, or smaller inflows, of private capital were recorded in all major categories.

Recorded outflows of U.S. private capital reached about $10 billion—some $3 billion larger than in 1970 and more than double the average of the 1960's. Outflows for direct investment rose, reflecting both a further increase in outlays for foreign production facilities and an extension until the end of February 1972 of the requirement to meet the ceilings for 1971 under the direct investment controls. Net additions to foreign assets reported by U.S. banks rose sharply to about $3 billion, as relatively higher interest rates abroad focused demands for funds on the U.S. market. The exemption of export credits from the voluntary ceilings toward the end of the year may also have led to increased foreign lending. Foreign claims reported by U.S. nonbank institutions also rose, but it is believed that many of the transactions affecting the foreign assets of U.S. corporations and of other investors other than banks were of types that are not captured by the statistical reporting system, and are therefore reflected in the residual "errors and omissions" in the balance of payments accounts.

The recorded inflow of foreign private capital (apart from liquid assets in U.S. banks) dropped sharply from $5 billion in 1970 to only about $2 billion in 1971. Foreign investors had placed substantial amounts in U.S. direct investments and corporate stocks in 1970, but under the pressures of exchange rate uncertainties and a weak U.S. economic performance in 1971, such inflows ceased, and at times there were sizable net outflows. Borrowing abroad by U.S. corporations to finance overseas direct investment or for other purposes also diminished in 1971.

U.S. banks further reduced their borrowings from the Euro-dollar market in 1971, as the increase in the cost of funds in that market relative to costs in the United States outweighed the advantages of retaining the reserve-free Euro-dollar borrowing bases established by the Federal Reserve with a view to moderating the liquidation of such borrowing. By the end of the year borrowings of U.S. banks from their foreign branches as registered in the U.S. balance of payments accounts had dropped to $1.3 billion, a reduction of $5.0 billion for the year and $14.1 billion from the peak in October 1969. U.S. Government securities that had been offered to the branches at attractive rates earlier in the year in order to slow the pace of the withdrawal of funds borrowed abroad were allowed to run off after mid-August.

In addition to the net recorded outflow of U.S. and foreign private capital in 1971—which aggregated about $15 billion—the unrecorded payments element in the U.S. international accounts rose to more than $9 billion. The combined total of $24 billion was about $15 billion greater than the comparable figure for 1970. Such unrecorded net outflows reached their peak in the period of hectic speculation preceding the August 15 measures taken by the United States.

YEAR-END PERSPECTIVE

As 1972 began, the events of 1971 clearly had set in motion strong forces tending to restore equilibrium in the U.S. balance of payments. The exchange rate realignments achieved in December were substantial, and they could be expected over time to move the trade balance into a surplus position more in accord with the normal role of the United States as a supplier of real resources to less wealthy countries. Moreover, such a realignment of rates should also have favorable effects on capital transactions—reducing the incentives for outflows of U.S. capital and restoring the basis for resumption of sizable inflows of foreign investment capital to the United States. In addition, impetus has been given to work on remodeling the structure of the international monetary system—especially regarding the management of international reserves and the process for adjusting exchange rates—so that the system will be less crisis-prone and more capable of making the timely adjustments required to avoid persistent deficit or surplus positions among countries.

There can be little doubt that the process of strengthening the U.S. trade and payments balances will take considerable time. It will probably be a year or more before there are clear signs that the necessary adjustments in basic transactions are taking place. Such adjustments are slow to develop even under the best of conditions, and in 1972 they will probably be further delayed by a faster growth of demand for goods and services in the United States than elsewhere. Consequently, there should be no cause for undue concern if the U.S. deficits are not quickly reversed. On the other hand, restoration of a secure equilibrium will require the pursuit of active policies both here and abroad to foster noninflationary economic growth and to accommodate the necessary redistribution of trading surpluses and deficits. □

This material will appear as Part 1 of the Board's
ANNUAL REPORT for 1971.