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The Quest for Full Employment and Economic Stability: 1960-1966

SINCE THE END of World War II, full employment, rising productivity, and a stable price level have been major objectives of economic policy in the United States, as they have in every other industrial country. All segments of our society—businessmen and labor leaders, farmers and urban workers, educators and legislators—now accept and endorse these objectives, particularly the need for full employment. Each year the President's Economic Report reaffirms allegiance to the principles of the Employment Act of 1946. Each year the Joint Economic Committee appraises the President's program for promoting "maximum employment, production, and purchasing power," and prods both the Congress and the executive to pursue whatever measures seem needed to achieve or maintain full employment and economic stability. Each year scores of governmental, business, labor, and civic groups, besides many hundreds of individual economists and other intellectuals, join in the continuing debate on the most appropriate means of achieving the broad economic objectives

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on which Americans are so generally agreed. The present meeting is one of many such efforts to seek better ways of moving toward our national objectives.

I

The constant attention that we give to public economic policies is proof enough, if any were needed, that the economy rarely performs as well as we think it should. True, we have made considerable progress toward full employment and economic stability in our generation, and we have accomplished this while preserving the essentials of political and economic freedom. Financial crises, which frequently disrupted economic life in earlier times, no longer exacerbate our troubles. Expansions of aggregate economic activity have tended to become longer. Contractions have become both shorter and milder, and the business cycle has lost much of the terror that it held for our fathers. Not only that, but the trend of output per man-hour, which is the most vital source of improvement in the general welfare, has moved upward faster than in earlier decades of this century. These gains are impressive when viewed against the background of past experience. However, the yardsticks that we apply to the performance of the economy have also tended to become more exacting, and in any event we have not escaped our share of disappointments. While the level of both employment and production has been generally high and rising during the past twenty years, we have experienced some troublesome recessions. Even in years of extremely brisk activity, such as 1956 and 1966, large groups of people—notably Negroes and teenagers—have continued to be subject to a higher risk of unemployment than the working population at large. And even those workers who have had the good fortune to hold down steady jobs at rising wages

have found that their improved money earnings, and also their accumulated savings, are partly illusory on account of the upward tendency of prices.

Economic instability has not yet vanished in our country, any more than it has vanished in any other country that values freedom sufficiently to practice free enterprise on a major scale. Nor, for that matter, has it vanished in the Socialist world where economic life is largely organized on the basis of state edicts. For example, Czechoslovakia experienced a recession in 1963, Communist China suffered a great depression after 1959, Yugoslavia has found it prudent to encourage many of her workers to look for jobs in Western Europe, the Soviet Union has suffered substantial unemployment of the seasonal and frictional type, and Poland has struggled for years with the burden of inefficiency resulting from the practice of requiring its industrial enterprises to absorb more workers than they need. And just as it is impossible to find, whether we look West or East, any final solution to the problem of unemployment, so also it is difficult to find substantial stability of the price level anywhere. Indeed, the advance of the price level of our total output, although it has reduced the purchasing power of the dollar by about 40 per cent during the past twenty years, still ranks as one of the better records of the postwar period.

These imperfections of economic achievement, both in our own past and in other parts of the world, need to be recalled at a time when the course of our economy has again become sluggish. Only two years ago we boasted that the economic expansion which started early in 1961 had already proved more durable than any of its predecessors under peacetime conditions. Now, despite a tremendous upsurge of federal expenditure, which is bound to continue for some time on account of the war in Vietnam, many economists are concerned that our

nation may once again be on the brink of recession. Only a short time ago the view was spreading in business and governmental circles that monetary and fiscal policies would henceforth adjust the aggregate demand for goods and services so closely to what the economy can produce at full employment that the danger of recession need no longer be taken seriously. Now, many economists are questioning the skill of governmental policymakers and some are even suggesting that governmental policies have a chronic tendency to destabilize the economy. Any such sweeping generalization can hardly be justified. Nevertheless, in view of recent shifts of fortune and opinion, it may be useful to stop and consider some of the difficulties in the management of prosperity; in particular, how public policy drove the economy forward after 1960, why rapid expansion has temporarily given way to sluggishness, and what guidance can be derived from these experiences for the future. That is my purpose in this evening's lecture.

II

The main source of our national prosperity has always been the hopefulness, initiative, skill, and energy of the American people. By and large, we have also been blessed with good government and with public policies that have left large scope for the expression of these qualities. The increasing attention of government to the problem of full employment and economic stability has led in our generation to ever-changing permutations of policy and they too have left their mark on the character and rate of economic progress. This has been singularly true of the years since 1960 which have been characterized by much boldness and innovation of governmental policy in the economic sphere. History, however, does not divide

itself neatly into stages or periods. What happened after 1960 was conditioned by developments in the immediately preceding years.

Taken as a whole, the decade of the 1950's experienced substantial advances in production, employment, and living standards. The later years of the decade, however, brought difficulties in quick succession. The recession following the Korean War came to an early end under the impetus of stimulative governmental policies. But as so often happens in a modern economy, the confidence of the business community soon spilled over into excessive exuberance. During 1956, business construction and the machinery and equipment industries forged ahead at an extremely rapid rate, while the output of the consumer goods trades became sluggish and homebuilding actually slumped. The average level of prices advanced swiftly in wholesale markets, but costs of production rose faster still and profit margins shrank. These and other imbalances gradually undermined the process of expansion. In July 1957, a recession got under way; and although it proved to be brief, it was the sharpest decline of aggregate activity in the period since World War II. The recovery that followed was strong at the outset, but it soon faltered and it did not return the nation to full prosperity. In the spring of 1960, when the unemployment rate was still 5 per cent, the economy again lapsed into recession. During this decline of activity, total output held up exceptionally well. But when the labor force and productivity keep increasing, the mere cessation of growth in physical output suffices to create trouble. Unemployment mounted during 1960 and reached 7 per cent in the spring of 1961.

The unsatisfactory performance of the economy in the late 1950's can be blamed in part on governmental timidity or excessive concern over inflation. There were, however, good reasons for concern and caution. The inflation of 1956–57 was

fresh in people's memories. President Eisenhower and other high officials realized that the advance of prices would have been smaller if they had moved as promptly and as energetically to curb the excesses of the boom as they had previously moved to check the post-Korean recession. It was only natural that men in authority were resolved not to repeat the mistake. But once the recession started in 1957, the government could not very well remain aloof. Some prominent officials and many private citizens urged a prompt reduction of personal and corporate income tax rates. They pointed out that the nation was still functioning with a tax system that had developed under wartime conditions, and they argued that a lightening of the tax burden would strengthen incentives, enlarge economic horizons, and thereby release fresh and enduring forces of expansion. This compelling plea went unheeded because of fear of budgetary consequences. Instead, credit conditions were eased and federal spending was allowed to expand. The decisions to increase spending did not come at once; they came in a long series, sometimes grudgingly, and thus spread out over months. But when the successive small accretions were finally added up in late 1958, it was discovered that they came to a much larger total than our fiscal authorities had either planned or advocated—indeed, that they made a larger dent in the budget than, say, the $5 billion tax cut that was then being urged would have entailed.

The main impact of the new federal spending programs came after the economy began recovering. A cash deficit of $13 billion, which still stands as the largest annual deficit since 1946, piled up in the fiscal year ending in June 1959—a year of continuous business expansion. This emergence of a huge deficit at a time of rather rapid economic advance was merely the most dramatic of a series of developments that cast doubt on the financial policy of the government. Over a long stretch of

history, it had been characteristic of the level of wholesale prices to fall during contractions of aggregate activity, thereby erasing all or part of the advance that had occurred during the expansion phase. In the recession of 1957–58 wholesale prices departed from rule, actually rose, and thus gave fresh support to the widely held theory that we are living in an age of inflation. This sombre view about the future was reinforced by the deterioration in the balance of payments. During 1958, imports rose sharply, exports fell, and our stocks of gold were cut by two billion dollars. More ominous still, foreign financiers, who hitherto appeared to have unbounded faith in American finances, began to whisper serious doubts whether the integrity of the dollar could be counted on in the future.

Financial developments during 1958 and the fears which they engendered thus strengthened the determination of governmental authorities to try to prevent, now that the economy was again advancing, the sort of excesses that had led to an inflationary boom during 1956–57. Both our international political position and the interests of the domestic economy clearly required better management of prosperity. Having moved too slowly to restrain the preceding expansion, they were ready to move with all necessary speed this time. Still embarrassed by the increase of the discount rate in August 1957, which came when the boom was already turning into recession, the monetary authorities now took steps to restrain the expansion of credit almost as soon as the first blush of economic recovery was recognized. Before 1958 ended, free reserves of the commercial banks were already wiped out. Pressure on reserves was sharply intensified during 1959. In consequence, the money supply began to decline and interest rates moved up with extraordinary speed. Meanwhile, the budgetary authorities brought the expansion of federal spending to an abrupt

halt. Since tax revenues continued to pile up as economic activity grew, the budget moved from an enormous deficit in early 1959 to a sizable surplus twelve months later. Taken together, these fiscal and monetary measures accomplished one of the most violent shifts on record from a policy of stimulation to a policy of restraint.

The abrupt shift of policy proved more restrictive than government officials planned or expected. Largely as a result of their actions, the economic expansion that started in April 1958, came to a premature end and unemployment rose at a time when it was already excessive. These unhappy consequences, however, had their redeeming side. The very abruptness and magnitude of the policy shift routed an inflationary psychology, demonstrated that ours need not be an age of inflation, forced businessmen to reduce waste and improve efficiency, created sufficient slack in the labor market to impede substantial wage increases, and thus reestablished stability in costs and prices. That these conditions were produced without causing a collapse in the state of confidence was an accomplishment of no small significance. The aggregate demand of final buyers, both domestic and foreign, kept growing throughout the recession of 1960–61. Fortunately, the monetary authorities reduced the discount rate one month after the recession started in 1960, instead of raising it one month later as in 1957. The easing of credit helped to maintain aggregate demand and thereby hastened the end of the inventory adjustment. Fiscal policy, in the meantime, remained stubbornly quiescent. Governmental authorities were in no mood to tolerate larger expenditures, nor would they countenance a tax cut which was again being urged by capable and disinterested citizens. In February 1961, economic expansion resumed and the administration's expectation of an early upturn was vindicated; but before this happened, the nation's electorate decided in a

close presidential election to entrust power to the Democratic party.

III

In the course of the campaign of 1960, John F. Kennedy promised that if he were elected president, America would get moving again. He lost no time in giving a new and bolder twist to economic policy. Although his administration can hardly be credited with initiating economic recovery in 1961, it did assume at once a very active role in nursing the recovery and in turning what might have been an ordinary expansion into a remarkable upsurge of the economy. Both political and economic circumstances favored an expansionist policy. On the one hand, the danger of inflation seemed quite remote after three years of stability in average wholesale prices and in unit costs of production in manufacturing. On the other hand, the persistence of slack in industrial capacity and in the labor market created a sense of impatience with conservative financial policies. Something new was expected of the new administration. The merits of an expansionist fiscal policy—particularly the advantages of a reduction of income taxes over an increase of governmental expenditures—had been extensively debated since 1957, and the nation was in a mood to try some fiscal experiments.

In the first year of his administration, President Kennedy chose to move cautiously. By and large, he left it to his advisers to popularize the teachings of the "new economics," to give a scholarly dress to the theory of using fiscal devices to close the gap between actual and potential output, to create a vision of an economy that might soon be recession-proof, to demonstrate that the full-employment surplus (or deficit) is a better index of the degree of fiscal stimulation than the actual

deficit, to show that the quest for actual budgetary balance could be self-defeating, and to quiet any lurking fears of inflation by suggesting guidelines for the proper behavior of prices and wages. The President himself was more concerned with advancing specific policies for which the public was prepared —such as speeding of procurement and construction in the interests of recovery, raising agricultural price supports, liberalizing social security, lifting the minimum wage, extending governmental programs for education and introducing health insurance for the aged. To be sure, the President did recommend an investment tax credit, but he coupled it with tax increases that would prevent any loss of revenue to the Treasury. He also suggested legislation for stand-by authority under which the President could temporarily reduce individual income tax rates and accelerate spending on public works; but he was much too wise about political matters to expect these measures to win congressional approval in any near future. President Kennedy's caution was plainly reflected in his Budget Message of January 1962, which called for a small surplus in the next fiscal year.

Even at the outset, however, the budgetary practice of the new administration was less orthodox than the President's rhetoric. Plans for federal spending were repeatedly revised upward during 1961, and actual expenditures followed suit. A surplus in the cash budget of $3.6 billion in 1960 was followed by a deficit of $6.8 billion in 1961—the first of an unbroken series of deficits that is still continuing. Monetary policy also eased and gave strong support to the liberal expenditure policy. As expected, consumer spending responded to these stimuli and so too did investment in inventories. Business investment in plant and equipment failed, however, to develop the vigor that is characteristic of the recovery stage of the business cycle. By the first quarter of 1962, new orders and contracts for

plant and equipment were merely 13 per cent higher than a year earlier, in contrast to increases of 86 per cent, 43 per cent, and 31 per cent during the corresponding stage of the three preceding expansions. Unemployment diminished, but its rate of decline was abnormally slow. Evidently, the recovery was not proceeding as well as had been hoped, despite the large fiscal and monetary stimuli.

The weak link in the chain of economic recovery was business investment in fixed capital. In popular discussions, this was generally attributed to the existence of excess industrial capacity. However, a good deal of idle capacity always develops in the course of a business slump, and yet this condition has never been a bar to brisk expansion of investment once confidence recovers. New firms are then established in larger numbers; existing firms in turn speed investments associated with innovation; firms that have done well despite the slump enlarge their capacity in anticipation of stronger markets; while many of the firms that have fallen behind in the competitive race finally embark on substantial programs of modernization. If these responses were not strongly felt in 1961, the reason was a want of sufficient confidence. Overinvestment in 1956–57, the steadily rising trend of wages, the tendency of profit margins to shrink during the past dozen years, the sharply reduced rate of economic growth during the past three or four years—all these factors contributed to business caution, and so too did the coming of a new administration whose economic policies could not as yet be fairly assessed. Many businessmen were concerned that trade unions, which had contributed to the victory of the Democratic party at the polls, would soon become bolder in their demands for higher wages and larger fringe benefits. Some feared that larger governmental spending, however favorable to markets in the short run, would in due course be followed by higher taxes. Others feared that direct controls of

prices might eventually be undertaken by the government in order to check the inflationary pressures that would result from its fiscal and monetary policies, and still others were concerned on all these grounds.

The uneasiness of the business community reached a climax in April 1962, when President Kennedy moved sternly to force the steel companies to rescind the price increase that they had just posted. This action by the President had no clear sanction in law and it caused consternation in business circles. Men reasoned that if the government could coerce or punish the steel industry today, it might move next against the automobile industry or the aluminum industry or any other. Since the beginning of 1962 economic recovery had shown some signs of hesitation. Now, with confidence shaken and a large inventory adjustment in the steel industry unavoidable, the continuance of business expansion became more doubtful. The stock market reflected the mood of the time by experiencing its sharpest break of the entire postwar period. Orders for machinery and equipment were cut back here and there. Private borrowing stopped rising, raw materials prices softened, profit margins narrowed, and unemployment stopped declining. The curve of industrial production, which had risen smartly until April 1962, flattened out for the rest of the year.

Fortunately, an imminent recession was forestalled. Recognizing that the government's handling of the steel price problem had disturbed the business community, President Kennedy turned at once to the difficult task of rebuilding confidence. In one address after another, he and his lieutenants now stressed the dependence of our national prosperity on free markets, higher profits, and larger investment in fixed capital. These reassurances were soon followed by measures to reduce the tax burden borne by the business community. In July 1962, the Treasury announced that business firms could henceforth

reckon their income taxes on the basis of shorter and more realistic estimates of the life of depreciable facilities. This basic tax reform was long overdue and it was welcomed by businessmen. With the President's prodding, the Congress enacted later in the year an investment tax credit which had already been proposed in 1961, but which was now substantially modified to make it more acceptable to the business community.

In the late summer of 1962 the President made his boldest move. His studies of the tax policies of other countries had convinced him that our tax system was a heavy drag on enterprise and investment. In view of the slowdown of the economy, a "quick" temporary tax cut had its appeal, but the Ways and Means Committee of the House of Representatives was more interested in permanent reform and legislation of this character could not be adopted quickly. In the circumstances, the President concluded that the time was right to announce his intention to request the Congress at the beginning of the next session to adopt a sweeping reform of the income tax, the main thrust of which would be a massive reduction of tax rates for corporations and for individuals in every income bracket. This tax proposal marked a radical departure in economic policymaking. In 1958 and again in 1960, when the country was experiencing recession, a tax cut had been repeatedly urged as a recovery measure that promised prompt results. Now, the purpose was to remove the fiscal drag on an expansion which was still under way, to extend thereby the advance of prosperity, and to risk fiscal deficits for an indefinite period to realize this objective.

The new tax policies and the new tone of governmental pronouncements had the desired effect on business and investor sentiment. Fears of hostile governmental intervention in the day-by-day activities of business firms subsided. Although many businessmen did not like the budgetary implications of a

massive tax cut at a time when a deficit was already in the making, they also were quick to see that stimulation of the economy through tax reduction would serve to strengthen the private sector of the economy. In any event, the policy of favoring investment was a significant departure from the traditional policy of the Democratic party, and this fact was not lost on the business community. With optimism reviving and the state of inventories in better shape, economic conditions in late 1962 were ripe for a new wave of expansion. By the end of the year, business commitments for investment in fixed capital began rising again, and fears of an early recession soon vanished.

In all, about a year and a half elapsed between President Kennedy's announcement of his plan for tax reduction and its actual enactment. There were two major reasons for the long delay. First, the President's fiscal program, as presented to the Congress early in 1963, called for numerous revisions in the tax laws as well as a general tax reduction; and while the latter was welcomed widely, the former evoked powerful opposition. Second, the President projected an increase of budget expenditures of $4.5 billion for the next fiscal year besides a net tax reduction of over $10 billion. Many influential citizens who supported a reduction of taxes were sharply opposed to a simultaneous increase of expenditure on the ground that such a fiscal policy would entail a protracted series of deficits. The fate of the President's program therefore seemed very uncertain for a time. But as the issues surrounding the program were debated within and outside the halls of Congress, it became increasingly apparent that the President's main objective was the tax reduction, and that he would yield ground to his opponents on other parts of the fiscal package. More and more citizens therefore came to feel that they would not need to wait much longer for a reduction in taxes. Finally, in March 1964, when Lyndon Johnson was already carrying the burdens of the

presidency, the tax cut became law. But months before that, the growing expectation of its adoption stimulated individuals and business firms to plan and spend more daringly. The expansion of economic activity, which was gradually cumulating of its own momentum, thus moved ahead on a wave of increasing confidence. The gross national product, expressed in real terms, rose 4 per cent between 1962 and 1963 and well over 5 per cent between 1963 and 1964.

IV

By early 1964, the expansion of economic activity had already lasted longer than the average duration of a business-cycle expansion. Nevertheless, the economy gave every indication that the advance would continue. Throughout 1964, as production and employment continued to rise, the structure of economic activity remained well balanced. A much faster pace in the output of business capital goods than in the output of consumer goods was only beginning. The ratio of inventories to sales in major branches of production and trade remained low or moved still lower. The wholesale price level was substantially steady. Although consumer prices kept rising, the advance was gentle. Although wages kept increasing, they advanced at nearly the same rate as the over-all improvement in productivity, so that unit costs of production remained quite stable. Profits grew with the volume of business, besides benefiting from revisions in the tax laws—among them, a reduction of income tax rates which became effective during the year. Stock prices moved up, but no faster than corporate earnings. With prices in our wholesale markets steady, while much of the rest of the world practiced inflation, exports rose sharply and a larger surplus on merchandise trade piled up than in any year since 1947. Meanwhile, interest rates remained fairly

steady. In view of the still precarious state of the balance of payments, the monetary authorities sanctioned a moderate rise of short-term market rates of interest; but the interest rates of largest significance to businessmen—customer rates on bank loans, bond yields, and mortgage yields—remained at or below the level reached at the bottom of the recession in 1961.

Moreover, while federal revenues in 1964 continued to fall short of expenditures, the deficit now reflected lower tax rates rather than any further increase of spending. In the debates that preceded the Revenue Act of 1964, some citizens had urged larger federal spending as the best way to stimulate the economy, others argued for tax reduction, and still others felt that it would be well to travel both roads at the same time. President Kennedy was favorably inclined to the mixed approach, but he put much the heavier emphasis on tax reduction. Even so, the Congress balked. The preamble to the House bill explicitly assigned top fiscal priority to tax reduction, with debt reduction next. This meant, as Congressman Wilbur Mills explained to the House, that the nation was choosing tax reduction, and rejecting larger spending, as its "road to a bigger, more progressive economy." In order to assure adoption of the tax cut, President Kennedy assented to the preamble and President Johnson did likewise a little later. Indeed, in his first Budget Message, presented in January 1964, President Johnson called for smaller expenditures under the administrative budget in fiscal 1965 than in fiscal 1964. With this much assured, the Senate promptly passed the House bill with only minor revisions. And in line with the new fiscal policy, federal spending actually stopped rising for a time. From the third quarter of 1963 to the first quarter of 1965, cash expenditures remained virtually constant. Thus, private enterprise and private demand once again became the great energizing force of the economy.

At the end of 1964, economic activity had already been advancing for almost four years. The expansion was proving remarkably durable, but it was not yet exceptionally rapid or intense. This very fact, no less than the deliberate economic planning of the time, contributed to the prolongation of the advance. If the investment in plant and equipment was sluggish at the start, this facilitated more vigorous activity later. If the investment in fixed capital and in inventories was checked in 1962, that too contributed to greater activity later. If the shift toward public policies that were more mindful of business interests took place gradually, that in its turn helped to keep business optimism within moderate bounds. The expansion was thus the product of many causes, and not the least among them was the inheritance of price and cost stability. As late as 1964 there was still a fair amount of slack in the economy, and this condition continued to exercise a restraining influence on the market behavior of both businessmen and labor leaders. The fact, moreover, that productivity improved somewhat faster after 1960 than in the preceding quinquennium made it easier for business firms to pay higher wages without incurring higher costs per unit of output. In the environment of rough stability of costs and prices that ruled until 1964, there was little reason to accumulate inventories as a hedge against inflation. Nor was there any need to rush investments in fixed capital on the ground that costs were likely to be appreciably higher next year than now.

Thus, our economy in 1964 had the qualities of order and balance, besides considerable momentum from within the private sector. To be sure, signs were not lacking that the vigor of expansion was rapidly reducing the slack in productive capacity. Prices of sensitive raw materials had begun rising in spirited fashion as early as the fall of 1963. By the late summer of 1964 a significant increase had already occurred in the number

of business firms reporting slower deliveries of merchandise. In the closing months of 1964, price increases in wholesale markets—while usually quite small—had become rather widespread. Toward the end of 1964 the unemployment rate for married men—who constitute, of course, the more skilled and experienced part of the labor force—had dropped to the level that ruled during the boom of 1956–57. By the end of the year, the length of the average workweek in manufacturing was already at the level reached during the Korean War. However, in the exhilarating economic and political atmosphere that ruled in the closing months of 1964, it was easy to overlook these and other indications of increasing pressure on the nation's available resources.

V

Clearly, no small part of the economic improvement was due to the government's tax policy combined with monetary ease. With the unemployment rate still close to 5 per cent at the beginning of 1965, it seemed only fitting and proper to the managers of our national prosperity to press harder the general policy of economic stimulation that had proved so dramatically successful. The second installment of the income tax reduction for corporations and individuals became effective in January, but that was deemed insufficient. The President urged in addition a reduction of excise taxes, and this proposal evoked such enthusiasm in the Congress that only thirty-four days elapsed between the introduction of the excise bill and the President's signature. The new law aimed to reduce excises by $2.2 billion in the fiscal year beginning July 1965, and by nearly $5 billion on a full-year basis when all the reductions would take effect. These tax reductions were not yet the whole of the fiscal stimulus applied in 1965. With the war in Vietnam intensifying and

new civilian programs clamoring for governmental favor, the fiscal philosophy enunciated in the preamble of the Revenue Act of 1964 was quickly forgotten. By the last quarter of 1965, the annual rate of federal cash expenditure was already $12 billion higher than in the first quarter.

These fiscal expedients imparted, of course, a fresh stimulus to economic expansion. Since the economy was now booming, governmental revenues rose despite the new tax reductions. Nevertheless, the deficit increased during 1965, and this need for finance was reinforced by a tremendous upsurge of borrowing by business firms and consumers. On their part, the monetary authorities made sure that the growing demands for credit would be met. In fact, they supplied the commercial banks with reserves so generously that the banks were able to add to their investments in securities, besides adding abundantly to their loans. Indebtedness to commercial banks rose by $25 billion during 1965, in contrast to $16 billion during 1963 and $18 billion during 1964. Total debt, both public and private, grew by $96 billion during 1965, in contrast to about $77 billion during each of the two preceding years. With credit expanding all around, the money supply could not stand still. The nation's stock of money, which had grown at an average annual rate of less than 3 per cent between mid-1960 and mid-1964, rose at a rate of over 4 per cent between June 1964, and April 1965, and at a rate of nearly 6 per cent the rest of 1965. Thus, as the economy approached full employment, monetary policy became increasingly expansionist. And so, too, did fiscal policy. The full-employment surplus, which had become the official measure of fiscal stimulus, moved irregularly between 1961 and 1963, fell in 1964, and was nearly wiped out by the end of 1965.

The accelerating use of monetary and fiscal stimuli served to narrow very quickly the remaining gap, as the Council of Eco-

nomic Advisers reckoned it, between the nation's actual and potential output. As 1965 drew to a close, the nation could rejoice that the unemployment rate was finally down to 4 per cent—the level which the Council had previously adopted as a reasonable target for full utilization of resources. But the widespread upsurge of public and private spending produced also other and less welcome results—in wholesale markets, prices that were 4 per cent higher than in mid-1964; in consumer markets, prices that were nearly 3 per cent higher; in the labor market, wages that were beginning to rise at an increasing rate; and in the money and capital market, interest rates that were moving up sharply, despite an enormous expansion in the supply of credit. These evidences of strain on the economy's resources became stronger during 1966. By the fall of the year, wholesale prices rose another 2.5 per cent, consumer prices over 3.5 per cent, while interest rates reached their highest level in about forty years.

Worse still, the economy became seriously distorted by 1966. In the first place, as bottlenecks on the supply side became widespread, the hectic advance of physical production could not continue. Crosscurrents in the economy therefore multiplied and the high expectations of many businessmen were frustrated. Second, a large gap between the rate of growth of business investment in fixed capital and the rate of growth of consumer spending had already lasted three years, and this imbalance in the structure of production could also not long continue. Third, concern over possible shortages and slow deliveries caused inventories to rise faster than sales in the early months of 1966. Later in the year, as the growth of sales weakened, inventories began to pile up involuntarily. Fourth, profits became vulnerable as a result of the divergent movements of prices and wages. The advance of wholesale prices abated after mid-1966, mainly because of weakness in farm and indus-

trial materials prices, while the rise of consumer prices quickened. With profits high, the demand for labor strong, and the consumer price level rising at a disconcerting rate, the upward push of wages accelerated. Meanwhile, numerous factors slowed down the advance of productivity—among them, the poorer quality of newly hired labor, more rapid labor turnover, lesser diligence of employees, accumulating fatigue of workers and their managers, slower and less dependable delivery of materials and equipment, the need to keep much high-cost equipment in use, and the need here and there to bring obsolete equipment back into use. The net result was that the rate of increase of output per man-hour not only slackened, but fell below the rate of increase of wages per hour. With demand pressures, particularly in the consumer sector, beginning to wane, while unit labor costs were rising all around, a cost-price squeeze developed in the world of business.

These forces internal to the boom, which were now causing readjustments in the economy, were heavily influenced, but in conflicting directions, by governmental policy. Federal cash expenditures moved up with extraordinary rapidity, and reached an annual rate of $156 billion in the second half of 1966, in contrast to a rate of $130 billion a year earlier. Tax revenues also rose rapidly in 1966, largely, but by no means entirely, as a result of the boom. Higher social security taxes that had previously been legislated went into effect at the beginning of the year. A little later, some excises were raised and a speedup of tax payments was ordered. In the fall the investment tax credit was suspended. Nevertheless, as estimates of the full-employment surplus indicate, fiscal policy taken as a whole became even more expansionist in 1966 than in 1965.

But if fiscal policy was still highly stimulative, monetary policy became severely restrictive. As signs of inflation multiplied in 1965, the monetary authorities became concerned that

their policy of active credit ease was being carried too far. They were troubled by the deterioration in the basic condition of the balance of payments as well as by domestic developments. As characteristically happens during a boom, imports were now rising much more swiftly than exports. Besides, the war in Vietnam was causing large and increasing foreign exchange costs. In December 1965, the monetary authorities finally overcame their hesitation and raised the discount rate, despite strong opposition from the White House; but they continued for another few months to allow bank credit to grow at practically the same rate as before. By the spring of 1966, when it became apparent that the stimulative thrust of fiscal policy was not abating, they shifted bluntly to a policy of credit restriction, thus repeating a familiar pattern. Many businesses, even large and well established corporations, that sought to borrow from their commercial banks, now discovered that they would have to get along with less credit or try to find credit elsewhere. But other financial institutions—life insurance companies, mutual savings banks, and particularly the savings and loan associations—could not extend significant relief, since they were even more hard pressed than the commercial banks. In this constricted environment of finance, not only did interest rates move up rapidly from a level that was already abnormally high, but the public market for debt instruments became disorganized for a while, and total private borrowing in the final quarter fell to the lowest level for that season since 1962.

The credit squeeze reinforced the gathering forces of readjustment in the economy. The homebuilding industry, which is peculiarly dependent on credit, became the outstanding casualty of financial stringency. Many real estate firms and small businesses in other lines of activity were injured. Moreover, the high interest rates brought depression to the bond market, and

became a major negative influence on the stock market as well. Tight money, however, was not the only factor now disciplining the boom. With the scope of economic expansion narrowing, labor costs rising, profit margins shrinking, construction costs running well above investors' estimates, uncertainty about the course of federal finances growing, and the business mood gradually becoming less exuberant, powerful forces besides tight money operated to bring the investment boom to a close. Consumer markets also lost their vigor as many families began practicing stricter economies in order to cope with the rising cost of living. In the meantime, inventories soared and the need to bring them into closer relation to sales cast a cloud on the economic outlook for the months immediately ahead.

VI

The recent sluggishness of the economy has inevitably led to much questioning of governmental policy. In particular, the monetary authorities have been blamed for bringing on a damaging credit shortage and unacceptably high interest rates last year. The critics are undoubtedly right if they mean that the shift from easy to tight money need not have been so blunt. But the complaint of some goes deeper; namely, that the government should have seen to it that interest rates remained at the moderate level that ruled until mid-1965. It is doubtful whether such a result could have been achieved. If the monetary authorities had attempted to peg interest rates, the boom would have become still more intense and the demand for credit would have risen still faster. The resulting open inflation, quite apart from other grave consequences, could have made interest rates rise eventually even more than they did. After all, when the price level is going up fast and constantly, lenders will in the end seek to be compensated for the depre-

ciation of money during the period of the loan, and no central bank can force lenders to do anything else. As it was, the advance of interest rates before April 1966, merely reflected the fact that the demand for credit had become so intense that it rose even faster than the extraordinary rise in the supply of credit. It was only then that the authorities stepped bluntly on the credit brake.

The fiscal authorities also have not escaped criticism. In view of the scale of federal spending and the escalation of the war in Vietnam, they have been repeatedly blamed for not raising income tax rates early in 1966. It seems likely that if defense costs had not been greatly underestimated, income taxes would actually have gone up. In that event, monetary policy would probably have been less restrictive, the homebuilding industry would have fared better, and some of the gyrations in financial markets would have been avoided. On the other hand, since retail trade was already beginning to display some signs of sluggishness, higher income taxes on individuals might well have accentuated the slackening rate of expansion. The case was perhaps stronger for a temporary increase in the corporate income tax or a suspension of the investment tax credit; but any such measure would also have come at an inconvenient time—that is, when profit margins were already beginning to recede. As things happened, the suspension of the investment tax credit did not become law until November, the very month when the Federal Reserve authorities had already begun relaxing the credit restraints.

The fact is that prompt or really good solutions are rarely, if ever, available for the imbalances generated by inflation. Once forces of inflation have been released, it becomes very difficult to bring them under control without some sizable readjustments in the economy. Mistakes in economic policy were undoubtedly made in 1966 as in every year; but they largely

derived from the fateful policies of 1965 when, despite the larger spending on defense, practically every weapon in the arsenal of economic stimulation was brought into use—greater monetary ease, lower income tax rates for individuals, lower income tax rates for corporations, lower excise taxes, and larger spending on programs of the Great Society. All this happened when moderate measures of restraint rather than accelerated stimuli were needed, so that the expanding economy could retain its balance. And so we finally come to the agonizing question: Why did the nation's policymakers, who for years had succeeded so well in monitoring a business expansion under difficult conditions, finally unleash the forces of inflation? Why did men who showed the ability to profit from experience succumb to one of the oldest weaknesses of governmental practice?

One reason, I think, is that they were misled by the very success that for a time attended their efforts. Economic expansion was continuing, and the level of costs and prices was remaining steady. Even the disequilibrium in the balance of payments no longer seemed so formidable. The export surplus had risen steadily since 1962 and, disagreeable though it would be to do so, the adverse capital movement could be handled by special measures—such as the interest equalization tax of 1963 or new guidelines for foreign loans and investments. With production, employment, personal incomes, and corporate profits going up steadily, and the consumer price level rising less rapidly than in earlier years, the nation's electorate returned the administration to power with an overwhelming vote of confidence in November 1964. Economic policies for and during 1965 were shaped in this atmosphere of success, to which the Council of Economic Advisers had made a very notable contribution. The massive tax cut was its bold conception, and the enactment of such a measure at a time when the economy

was advancing smoothly was a triumph of the "new economics."

The central doctrine of this school is that the stage of the business cycle has little relevance to sound economic policy; that policy should be growth-oriented instead of cycle-oriented; that the vital matter is whether a gap exists between actual and potential output; that fiscal deficits and monetary tools need to be used to promote expansion when a gap exists; and that the stimuli should be sufficient to close the gap—provided significant inflationary pressures are not whipped up in the process. The magnitude of the stimulus to be applied in any particular case involves, of course, difficult estimating and forecasting, but the Council's forecasts were apparently improving. Its economic forecast for 1962 was wide of the mark; it was better for 1963 and it was nearly perfect for 1964. In judging economic prospects for 1965, the diminished slack in the economy could not be ignored. But if the margin for expansionist policies appeared smaller on this account, the guidelines for prices and wages could increase it. That, indeed, was their basic purpose. Originally presented as a contribution to public discussion, they had by now been shaped into crisp rules that might lead to censure of violators or worse. With the price level nearly steady and unemployment still well above 4 per cent, it thus seemed tolerably safe as well as desirable to resort to fiscal and monetary stimuli on a larger scale than before. But as later experience demonstrated, neither trade unions nor business firms will act often or long in a manner that is contrary to their economic interests. Once slack in the economy was significantly reduced, expectations of stable prices began to fade, inflationary pressures reappeared, and their initial symptoms were already visible in 1964, as I previously noted.

The policymakers paid slight attention to these cyclical

symptoms, for their thinking was focused on bringing down the rate of unemployment—an objective to which the government was rightly committed. An unemployment rate of 4 per cent, or possibly somewhat less, had always been the objective of the administrators of the Employment Act. But in 1961 the figure of 4 per cent became official for the first time, and this inevitably added to public pressure for its prompt realization. However, the economic significance of any particular figure of unemployment does not stay fixed in a dynamic environment. In recent times, the labor market has changed profoundly as the numbers working part-time or intermittently grew relative to the stable full-time labor force, as voluntary unemployment became a larger factor in the total, and as job opportunities for the unskilled declined. These structural changes in the labor market tended to make it harder to reach an unemployment rate of 4 per cent merely by stimulating aggregate demand. But if this was the case, it was desirable by 1965 to shift the emphasis of economic policy from expanding aggregate demand to the correction of structural maladjustments. The administration read the evidence differently, and it did so in part because of the theoretical apparatus of the Council of Economic Advisers. Since the Council identified an unemployment rate of 4 per cent with a condition of practically full employment, this figure served as a constant in the equation for computing the potential output. The gap between actual and potential output, in turn, was attributed to a deficiency of aggregate demand; so that, in effect, any unemployment in excess of 4 per cent called for correction of an alleged demand shortage. This was a dangerous shortcut in analysis, since the gap could obviously arise, in whole or in part, from obstacles on the side of supply or from a failure of the constituent parts of demand and supply to adjust sufficiently to one another. To analyze the labor market on these principles, the Council

would have needed comprehensive statistics on job vacancies. Unfortunately, such statistics did not—and still do not—exist.

Faulty statistics compounded the difficulties of the policymakers. When industrial markets tighten, list prices for a time are apt to remain unchanged, while effective prices are raised by reducing special concessions or charging a premium. Since these common departures from list prices are largely ignored in the official index of wholesale prices, the rise that it registered in 1964 and 1965 undoubtedly understated the actual rise. Another statistical deficiency was still more mischievous. As originally calculated by the Department of Commerce, the annual rate of increase in the gross national product during 1965 was consistently too low, quarter after quarter, by amounts varying from about $2 to $5 billion. This cumulation of errors left its mark on economic thinking by underestimating the growth that was taking place, and therefore also exaggerating whatever gap may have still existed between actual and potential output.

Thus, the psychology of success, the novel guidelines for prices and wages, technical economic analysis, and its statistical accoutrements, all played their role in moving the nation to a more expansionist economic policy during 1965. But the role of philosophic views and political factors, which are always and inevitably present, may well have exceeded everything else. The main drive for an expansionist policy came from the executive establishment. The Congress generally acquiesced, and so too for a while did the Federal Reserve Board which still had some misgivings about the degree of caution that it had exercised in the past. Nowadays, the view is widely held in economic and political circles that a little inflation is tolerable because it can lead to a reduction of unemployment and some alleviation of poverty. The longer-run relations of inflation, unemployment, and poverty are less well understood. Thus, with

prosperity increasing, it seemed only proper to the President and his advisers to take bolder steps in behalf of the sectors of the economy that had been left behind by the march of progress. With income taxes already lowered, it seemed only just to reduce excises and thus aid both merchant and consumer, whether rich or poor. The growing involvement in Vietnam came gradually and it was not expected to be a major factor financially. As the year advanced, it became evident even to many of those who supported the guidelines policy that trade unions and business corporations either would not or could not discharge adequately the responsibility of holding back the tide of inflation which the government, in effect, had asked them to assume. Indeed, by mid-1965, the Federal Reserve authorities had already become gravely concerned about the course of events; but they were reluctant to take immediate measures that would run counter to the policy of the executive—the main source of governmental power. Time is always needed to carry out a significant shift of policy by a far-flung government of divided powers, particularly when the move requires restraints on expansion. In this instance, the difficulty was magnified by the political cost of returning to orthodox policies for fighting inflation.

Theories have a power that administrators, no matter how able, cannot fully control. By and large, economic policy during 1965 was still governed by the theory that stimulation of activity was reasonably safe as long as a gap existed between actual and potential output, no matter how small the gap was becoming or how rapidly it was being closed. When small inflationary signs appeared, they were at first not believed or dismissed as trivial. By the time a change in policy was attempted, it had already been pushed into greater stimulation than was intended. Thus, deliberately expansionist measures were carried along passively for a time as the desirability of a

shift in policy and how it might best be executed were being pondered by the managers of our prosperity.

VII

The course of economic policy in the United States in recent years, despite some disturbing misadventures, remains impressive. Since 1960 we surely have made progress in moving toward our national objectives. Production and employment rose substantially, the advance of prosperity became widely diffused, full employment was reestablished, and new doors of economic opportunity were opened up to underprivileged citizens. The government played a vital part in bringing about these gains by its imaginative, and yet pragmatic, approach to the nation's problems. When increases of federal spending failed to produce desired results, it shifted boldly to tax reduction, and thus made the psychology of confidence its ally in the quest for economic improvement. When structural maladjustments in the labor market became clearer, it proceeded to build on the modest beginnings of the Manpower Development and Training Act. And when inflation broke loose, it finally recognized that orthodox financial measures were better suited to our nation's genius than legal props for the badly bruised wage and price guidelines.

However, this willingness to learn from experience came much too slowly at times, and in any event recent years have brought disappointments as well as successes. Certainly, extensive unemployment lasted much too long, the disequilibrium in the balance of payments escaped correction, the federal government continued to run a deficit even when full employment was reestablished, the nation experienced another round of inflation and this, together with the large fluctuations in financial markets, resulted in a redistribution of wealth that injured

many defenseless citizens. Economic policy cannot escape a part of the responsibility for these failures, some of which may yet haunt us in the future.

Thus, governmental policies for dealing with the problem of full employment and economic stability have moved along a rocky road in recent years as in the past. Since the 1930's, economic policymakers have indeed demonstrated a capacity to learn from past mistakes. Too often, however, their memories have grown dim with the passage of time. Economic generals, not unlike their military counterparts, sometimes forget which war they are fighting, nor do they always know which war to fight. Nevertheless, significant progress has been made and we must try to extend it.

The needs are many, and so too are the opportunities. We need to become better aware of the limitations of the art of economic forecasting even as we try to improve it. We need to develop comprehensive data on job vacancies, so that it will no longer be necessary to guess whether or when a deficiency in aggregate demand exists. We need to improve our measures of prices and costs, so that inflationary pressures can be recognized more promptly. We need to develop quarterly projections of federal revenues and expenditures, similar to the information now compiled by the government on business sales expectations and investment intentions, so that the changing requirements of fiscal policy can be better evaluated than in the past or at present. We need to learn more about the subtle forces that shape the state of confidence. We need to develop policies for dealing with seasonal unemployment—a problem that we have largely ignored since the 1920's.

We need to learn to act, at a time when the economy is threatened by inflation, with something of the sense of urgency that we have so well developed in dealing with the threat of recession. We need to learn to make necessary shifts of eco-

nomic policy more promptly, so that they may be gradual instead of abrupt. And most important of all, we need to learn better than we yet have the basic truth that, while stability of the general price level will not of itself bring prosperity in the years ahead, we cannot very well maintain international confidence in the dollar or have sustained prosperity without it.