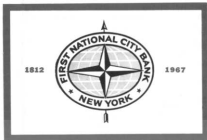


Monthly Economic Letter



General Business Conditions

Responding to an urgent Administration request, Congress last month moved swiftly toward restoration of the investment tax credit just five months after it had been suspended through January 1, 1968. The Administration has also released \$1.4 billion of funds for highway buildings, mortgage purchases and other purposes which had been held back since last December. For its part, the Federal Reserve has reduced reserve requirements on savings deposits and moved generally toward an easier money policy, in contrast to the rather cautious steps in the first two months of the year.

The marked shift toward stimulative policies was taken in many quarters as evidence that the economy was slowing down more rapidly than the Administration and monetary authorities had earlier anticipated. Secretary Fowler denied this in testifying before the House Ways and Means Committee. He insisted the decision to

urge restoration of the tax credit was based on the belief that the suspension had accomplished its narrow objective, namely a slowdown in capital investment. The 6 per cent surtax would still be needed, he said, by next July 1.

William McChesney Martin, Chairman of the Federal Reserve Board, took a similar view with respect to the surtax. Mr. Martin acknowledged, however, that the economy is slowing down.

Production Off Sharply

There is no doubt that the recent fiscal and monetary moves from Washington will, in time, help to spur the economy's growth rate. But in the meantime signs of a further slowdown continued to proliferate last month. Hard on the heels of the policy moves came the announcement that the industrial production index had dropped two full points in February, reflecting in part unusually severe weather conditions, but more importantly efforts by manufacturers to bring production into line with sales. At the same time, manufacturers' shipments of durable goods in February declined less than in coming orders, which had edged down from the previous month. As a result, the backlog of orders eased further.

So far, the drop in production levels has had a nominal impact on employment. The unemployment rate continued to hold at 3.7 per cent in February, virtually unchanged since late last summer. But the average workweek has declined 3 per cent since September. Manufacturers have reduced production by cutting overtime and adopting a shorter workweek. In part because of the sharp cutback in the average workweek, the February gain in personal income slowed to a rate less than half that of January.

The rather pronounced slowdown in economic

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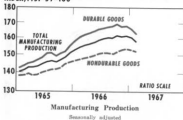
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growth, which many economists had not anticipated as recently as three months ago, has caused some to revise downward their earlier, rather optimistic, forecasts. Few, however, have gone so far as to suggest an old style recession. The Administration view has been that the current easing will be relatively mild and business activity will accelerate in the second half of the year. The reasoning behind this outlook is that capital investment will be buoyed by restoration of the tax credit, while an easier monetary policy will encourage a rise in consumer spending as well as a strong increase in home construction. Furthermore, government expenditures will continue to rise sharply.

There is no doubt that restoration of the 7 per cent tax credit will help to support plant and equipment outlays. However, other recent developments may be working in the opposite direction. The disappointing performance of corporate profits that seems to have occurred in the first quarter is likely to dampen the expansive mood of some business managements. Of greater importance is the new capacity coming on stream steadily in the face of declining sales. This has lowered the capacity utilization rate in manufacturing to about 87 per cent from 90 per cent in the fourth quarter of last year, making plant expansion in some industries less urgent than it was a few months ago.

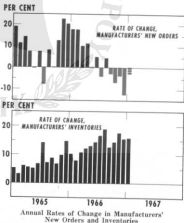
Despite production cutbacks in January, manufacturers' inventories grew a little faster than they had the month before. Manufacturing output was cut even more sharply in February (not shown in chart at right), and the rate of inventory growth was more than halved. In automobiles, however, the sharp contractions in production have only succeeded in holding inventories at about 1.5 million cars through the first three months of this year. At the end of March, dealer stocks amounted to roughly 65 days' supply, well above the normal supply of about 45 days.

Revival in Consumer Spending?

The cautious attitude of the consumer, reflected in auto sales, continues to hamper efforts to adjust retail inventories generally. Heavy snowstorms in the Northeast during the weeks before Easter cut sharply into the traditionally strong apparel sales. However, weather conditions were only a partial explanation for the sluggish performance of retail sales. Seasonally adjusted, clothing sales have been softening since late last summer, as have those of appliances, furniture, carpeting, and other home furnishings.

For nearly a year now, people have tended to defer new and replacement purchases of durable and semi-durable goods and to make do a little longer with their present automobiles, refrigerators, and apparel. This has partly reflected the slowdown in the growth of disposable income and the reduced rates at which households were accumulating liquid assets through most of 1966. Households have also been increasingly cautious about taking on additional instalment debt or expanding their charge account obligations.

The rapid expansion of the money supply in recent months has been reflected in an upswing in consumer liquidity. Experience suggests the initial effects of such an upswing in liquidity are generally reflected first in the markets for financial assets, but in time spread outward to dur-



Note: Seasonally adjusted. Change in new orders smoothed by three-month moving average. January figures are preliminary.

able goods sectors, particularly residential construction, and, with a somewhat longer lag, automobiles and appliances.

As yet, however, there are few signs of a substantial pickup in these sectors. Automobile sales have been particularly slow, having declined in February to a roughly 7½ million annual rate (seasonally adjusted, excluding imports) from an 8 million-plus pace earlier in the model year and 8.5 million of the '66 models. Dealers have been seeing more shoppers as the spring selling season has gotten under way. The question, however, is not whether retail sales including auto sales will improve over the next two to three months, but whether they will match the usual seasonal performance.

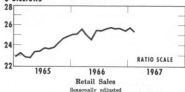
Monetary Developments

The turnabout in monetary policy dates from last November but the pace of Federal Reserve action in easing monetary conditions quickened significantly last month. Cuts in reserve requirements on savings deposits supplied the equivalent of about \$850 million in funds to expand deposits and credit.

The direction of change in the money supply—currency plus demand deposits—has been reversed from a decline at an annual rate of 1.7 per cent between last April and November to an increase of about 5.3 per cent (annual rate) since November. There was an unusually sharp increase in the money supply in March alone. The rise in time deposits has been especially rapid; since November, total money stock has grown almost \$12 billion, with time deposit growth contributing nearly 75 per cent.

The increase in money supply has been paralleled, of course, by a rapid expansion of total bank credit. Most of this growth in credit has been channeled into additions to the banking system's holdings of investments—mainly Fed-

\$ BILLIONS



eral and municipal securities. The increase in total bank loans has slowed down in recent months, and declined in February. March lending was enlarged by loans to meet corporate income tax payments.

The financing of corporate tax payments and continued high levels of inventories have recently tended to sustain business loan volume. However, certain other types of bank loans, notably consumer instalment credit, loans to sales finance companies, and real estate loans have declined. Furthermore, loan extensions to borrowers in food and metal manufacturing industries and in construction have eased.

With softening in economic activity being accompanied by vigorous monetary expansion, interest rates resumed a downward course in March. Rates on tax-exempt and short, medium, and long-term U.S. Government securities all declined substantially. Yields on corporate bonds held steady, owing to a record volume of new issues. Late in March, most commercial banks lowered the minimum business lending rate to 5½ per cent from 5¾ per cent.

With interest rate changes taking place on a broad front as April opened, a cut in the discount rate was widely expected in the market. In any event, the Federal Reserve has already given a clear signal that present economic conditions call for a stimulative monetary policy.

Review of Corporate Profits in 1966

The more comprehensive corporate reports becoming available over the past month indicate that while total earnings climbed to a new record last year, the improvement in profit margins came to a halt.

With additional reports bringing the total number of companies to 3,850, this Bank's tabulation shows aggregate after-tax profits of \$38.2 billion, an increase of 10 per cent from 1965. Among manufacturers alone, profits rose 9 per cent, to a total of \$24.1 billion.

The increase in earnings was broadly shared with nearly four out of every five companies

reporting improved results. All but three out of the total of 65 industry groups recorded higher earnings.

The overall improvement primarily reflected a hefty growth in sales volume as climbing defense spending, coming on top of a capital spending boom, boosted total demand. After the first quarter, however, spreading weakness in homebuilding, autos, and household durables began an erosion of profits in the consumer goods sectors that is still continuing.

Partly influenced by the shifting composition of demand during the year, productivity growth

Net Income of Leading Corporations for the Years 1965 and 1966

(Dollar Figures in Thousands)

No. of Cos.	Industrial Groups	Reported Net Income After Taxes		Per Cent Change	Net Worth-a Beginning of Year		% Return on Net Worth		% Margin on Sales-b	
		1965	1966		1965	1966	1965	1966	1965	1966
15	Baking	71,815	84,285	+18	602,714	607,375	11.9	13.8	2.8	3.1
13	Dairy products	290,249	321,826	+11	1,506,847	1,786,569	12.5	12.4	8.2	9.3
27	Meat packing	61,182	70,149	+15	1,164,812	1,258,197	5.3	5.5	9.6	9.7
14	Sugar	45,854	54,994	+20	473,977	521,009	9.5	10.5	4.5	5.8
84	Other food products	507,266	625,412	+12	4,482,838	4,718,279	12.4	12.5	4.8	4.4
14	Soft drinks	129,306	156,182	+16	616,211	678,688	21.1	22.8	7.2	2.8
17	Brewing	71,658	86,704	+21	648,546	679,374	11.1	12.8	4.5	4.7
13	Distilling	166,976	194,149	+16	1,265,746	1,731,294	9.6	10.6	4.5	4.7
12	Tobacco products	377,314	338,014	-10	2,355,793	2,390,294	12.3	12.8	4.5	4.7
78	Textile products	344,282	381,552	+11	2,362,690	2,395,919	11.4	11.9	4.5	4.7
85	Clothing and apparel	341,384	377,289	+9	2,922,685	3,117,664	10.3	10.9	4.5	4.7
23	Shoes, leather, etc.	71,842	84,149	+17	686,479	844,797	11.8	12.1	9.5	9.7
58	Rubber and allied products	344,640	431,847	+18	3,879,539	5,221,899	11.8	13.0	4.4	4.7
25	Lumber and wood products	219,981	224,234	+2	1,596,535	2,046,611	11.5	10.9	5.9	5.4
37	Furniture and fixtures	59,649	79,898	+19	458,352	499,075	12.8	14.2	5.8	5.6
27	Paper and allied products	576,746	671,178	+16	5,615,990	5,991,382	10.5	11.8	6.2	6.6
89	Printing and publishing	276,622	320,408	+21	1,600,781	1,796,885	16.9	18.1	6.6	7.1
79	Chemical products	1,485,396	1,796,906	+6	16,953,718	15,509,649	15.4	15.1	8.6	8.2
22	Paint and allied products	123,141	136,533	+11	987,540	1,077,254	14.1	13.9	5.6	5.5
29	Drugs and medicines	645,245	738,574	+19	3,559,821	3,277,284	22.2	21.9	11.9	10.8
29	Sewer, sanitation	391,894	335,965	-13	1,372,475	1,894,349	28.0	17.7	6.6	6.8
17	Concrete	4,638,119	5,174,628	+12	38,381,587	41,633,828	11.9	12.6	9.5	9.6
15	Glass products	21,870	22,541	+3	1,897,585	1,822,158	8.8	7.6	9.0	7.2
38	Other stone, clay products	21,791	230,449	+9	2,218,420	1,736,672	13.5	12.8	7.4	7.7
82	Iron and steel	1,189,567	1,186,562	+0	12,145,241	12,851,706	9.6	9.3	5.2	6.4
45	Nonferrous metal	738,735	1,065,587	+28	6,149,976	6,816,328	11.8	15.4	8.9	9.2
44	Hardware and tools	185,716	197,387	+6	792,549	923,461	17.1	19.2	4.7	7.9
60	Building, heat, power, etc.	143,563	171,786	+19	1,648,548	2,833,724	14.4	14.6	6.0	6.4
43	Other metal products	211,556	249,260	+18	3,498,782	3,833,724	16.6	11.9	4.2	4.6
44	Form, cast, metal, equip.	141,319	160,533	+13	1,648,548	1,712,881	12.9	14.0	4.9	5.2
45	Office, computing equip.	397,350	725,643	+82	3,410,581	3,934,966	18.7	18.4	8.9	8.5
23	Other machinery	688,574	875,415	+27	4,408,854	5,093,741	14.4	14.0	8.9	8.5
153	Electr. equip. & electronics	3,163,543	4,433,432	+41	7,866,496	8,697,072	18.8	16.4	4.8	4.9
20	Household appliances	179,387	178,512	-0	1,152,979	1,071,129	15.6	14.4	5.5	5.1
15	Auto and trucks	3,168,435	2,667,674	-16	18,256,294	14,891,819	17.8	17.8	7.8	6.5
61	Automotive parts	768,774	904,510	+17	3,952,807	2,934,266	18.4	16.5	4.9	5.5
59	Railroad equipment	164,563	129,865	-20	841,665	964,851	12.7	14.2	5.5	5.8
58	Aircraft and space	145,984	188,115	+29	5,293,724	3,825,388	19.4	15.5	3.2	8.9
109	Instruments, photo goods, etc.	397,666	475,544	+20	2,582,253	4,027,323	19.2	21.7	9.3	9.9
85	Misc. manufacturing	189,258	197,310	+4	1,388,522	1,511,749	15.5	18.9	5.4	8.1
2,239	Total manufacturing	22,860,882	24,974,854	+9	188,681,137	176,408,261	12.7	14.1	6.4	6.2
23	Metal mining-c	99,892	90,879	-9	643,788	769,234	12.5	12.7	11.8	12.1
15	Coal mining-c	94,488	63,187	-33	385,291	673,919	10.4	11.0	6.8	7.6
11	Other mining	67,432	34,431	-49	495,492	543,796	8.6	37.8	17.9	19.8
29	Total mining	257,812	188,503	-23	1,524,571	1,987,959	12.2	13.6	18.9	11.9
59	Chain stores-food	327,501	328,447	+0	2,614,696	2,764,607	12.5	12.2	1.3	1.3
79	Chain stores-various, etc.	270,577	281,190	+4	1,891,184	1,871,487	15.8	14.6	3.2	3.2
66	Department and specialty	408,127	449,833	+10	2,992,512	2,389,580	13.6	13.7	3.1	3.1
9	Mail order	347,895	346,988	-0	2,694,639	2,871,473	12.9	12.1	4.2	3.9
179	Wholesale and misc.	334,256	606,930	+81	2,448,867	2,768,913	13.8	15.0	2.6	2.6
392	Total trade	1,644,447	1,902,495	+16	12,434,869	13,482,443	13.2	13.4	2.5	2.5
76	Railroad	814,888	902,172	+11	17,622,359	17,746,694	4.6	5.1	8.9	8.8
86	Common carrier trucking	69,759	86,789	+24	513,799	581,668	11.7	12.9	3.9	4.2
19	Shipping	49,547	68,184	+38	634,677	699,455	7.8	9.9	6.7	7.9
47	Air transport-d	383,467	417,363	+9	1,299,216	1,297,797	29.8	29.8	6.9	7.9
27	Misc. transportation	355,828	119,897	-66	716,483	790,676	15.7	16.4	7.1	7.2
191	Total transportation	2,414,479	1,584,423	-34	20,698,672	21,229,556	4.9	7.5	7.5	7.7
244	Electric power, gas, etc.-d	3,844,313	3,475,965	-10	29,687,581	30,975,156	11.3	11.2	14.9	14.9
23	Telephone and telegraph-d	2,608,797	2,398,587	-8	20,807,462	22,204,611	9.9	10.4	14.6	14.6
267	Total public utilities-d	6,154,943	6,778,512	+10	50,748,128	53,177,761	10.8	10.9	14.2	14.6
81	Amusements	91,934	197,718	+21	791,096	843,776	11.6	12.7	5.2	5.2
43	Restaurants and hotels	61,936	74,300	+20	574,857	574,857	11.6	12.7	5.2	5.2
129	Other business services	217,469	267,614	+23	1,108,053	1,275,377	19.6	19.6	11.6	11.6
31	Construction	69,897	101,161	+45	773,964	812,821	11.6	12.5	4.5	4.6
102	Total services	462,276	583,199	+26	3,997,681	5,596,927	14.4	15.7	4.8	4.8
8	Commercial banks	1,108,098	2,289,669	+105	2,847,600	20,690,890	8.7	8.6	...	...
229	Fire and casualty insurance	218,223	254,164	+16	5,897,695	5,897,695	8.8	6.4	...	...
229	Investment trusts	907,279	1,133,668	+25	26,586,917	41,216,860	3.4	2.8	...	...
86	Sales finance	394,474	394,969	+0	1,226,095	2,485,096	12.8	11.6	...	...
79	Real estate	38,676	50,120	+30	582,122	554,793	7.3	9.0	...	...
429	Total finance	1,793,701	4,164,247	+131	36,948,919	76,058,582	8.4	5.4	...	...
3,852	Grand Total	34,873,795	38,888,934	+12	315,206,715	316,125,446	11.1	11.2	6.5	6.4

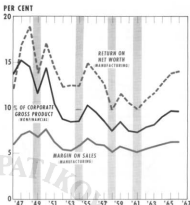
a-Net worth (listed previously as "Book net assets") is based upon the excess of total balance sheet assets over liabilities; the amounts at which assets are carried on the books may not represent present-day values. b-Profit margins are computed for all companies publishing such or gross income figures, which represent 66 per cent of the total number of reporting companies, excluding depreciation charges in some cases. c-Due to the large proportion of capital investments as well as from sales, c-Net income is reported before total property investments would be lower than that shown on net worth only. d-Figures in most cases exclude certain gains or losses on investments. e-Federal Reserve Board tabulation of all member banks; number of banks (8,189) is not included in total number of companies; earnings include profits and losses on sale of securities; net worth figures are annual averages.

was below average in 1966. This, combined with rising wages and higher costs of materials and supplies, put increasing pressure on profits as the year progressed. Several important strikes, notably in the airline, electrical equipment, and chemical industries, also affected profits adversely, particularly in the latter half of 1966. Moreover, higher Social Security taxes, together with increased depreciation charges arising from the tremendous growth of capital investment, were additional factors raising costs.

On the other hand, the high level of industrial activity permitted a firm price structure, a factor particularly important for capital-intensive industries such as petroleum, copper, aluminum, and paper. However, some industries, including synthetic fibers and building materials, were hurt by price weaknesses.

In terms of the key earnings ratios, 1966 was one of the better years since the Korean War. Nevertheless, the average profit margin, calculated for all nonfinancial corporations reporting sales figures, declined from 6.5 cents per sales dollar in 1965 to 6.4 cents last year. Increased investment, as represented by net assets of \$340 billion at the beginning of 1966, has been largely instrumental in maintaining earnings. Figured as a percentage of this investment, the return on net worth rose slightly to 11.2 per cent from 11.1 per cent in 1965.

As shown in the accompanying chart, these earnings ratios have remained at a relatively good level. This year, however, a number of unions are citing increased profits as a sign of "ability to pay" and demanding extra-large wage increases. But profits are not something fixed and available to be raided on demand. They are normally highly volatile, rising sharply in good times, and falling steeply when the business trend weakens. With the economy now



Corporate Profits After Taxes as a Per Cent of Corporate Gross Product and of Manufacturers' Sales and Net Worth

Source: Profits and corporate gross product for nonfinancial corporations, U.S. Department of Commerce. Return on net worth and profit margins for manufacturing corporations, FICB. Shaded areas represent years in which the low point of a recession was reached.

in the midst of a marked slowdown, it is clear that profit margins are being adversely affected.

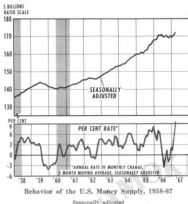
Moreover, profits provide both the incentives and means for investment and growth, which are the prime source of increased productivity and higher wages in the long run. The prolonged economic expansion of recent years is obviously related to the more stable trend of profits over this period. A healthy environment for profits is essential to a renewal of vigorous expansion in the economy.

Changing Views on Economic Policy

The sudden restoration of the investment tax credit and the moves toward easier money would seem to indicate a recognition by the the Administration and the monetary authorities that the business situation called for a switch in economic policies. But, in urging restoration of the tax credit, Administration officials last month insisted that the need for this action was not related to any weakening in the overall economy and that the proposed 6 per cent surtax would still be needed by next July 1.

A contrary view, however, was presented on March 17 by the Congressional Joint Economic

Committee in its report on the President's *Economic Report*. In an unusual "statement of agreement," both the majority and minority members of the Committee warned that the Administration's "optimistic midyear forecast may not eventuate, in which case a tax increase would be unwarranted." The Committee went on to call for a reduction in nondefense expenditures, which would reduce "the case for a tax increase even if the economy's expansion is restored during the second half of the year." The Democratic majority specified a cut of at least \$5.6 billion in nondefense expenditures for fiscal 1968.



Source: Board of Governors of the Federal Reserve System.

Defection from the "New Economics"

The policy rift between the Administration and the Joint Economic Committee (JEC) reflects something more than a difference of opinion about the business outlook. The Administration's current policies are based on a belief in "fine tuning" the economy, primarily by changes in Federal expenditures and tax rates. The "fine tuning" idea, in turn, is the latest manifestation of the "new economics" philosophy, with its stress on fiscal policy changes as the prime method for managing the economy.

The JEC, on the other hand, adopted its latest policy stand after lengthy exposure to sharply differing views on stabilization policies from a group of economic experts testifying on the President's *Economic Report* in February. What the Committee discovered is that a growing number of economists have come to downgrade the importance of fiscal policy as a determinant of economic activity. Instead, economists are increasingly impressed with the influence of monetary factors in shaping the course of the economy. The JEC's latest policy stance on fiscal and monetary policies, therefore, substantially reflects the shifting weight of economic opinion.

Thus, while the Council of Economic Advisers has continued to emphasize fiscal policy, the JEC this year has stressed a steady increase in the money supply as being vital for "restoration of economic growth and avoidance of a recession." The JEC's majority report stated:

The committee urges that the monetary authorities adopt the policy of moderate and relatively steady increases in the money supply, avoiding the disruptive effects of wide swings in the rate of increase or decrease.

In a minority report, Republican members called for increasing the money supply at a rate of 2 to 4 per cent a year, compared with a 3 to 5 per cent range recommended by the majority report. The accompanying chart shows the erratic behavior of the money supply over recent months.

The JEC's current policy stance represents a major reversal since last year. At that time, the Committee called for immediate enactment of a tax increase on a standby basis (to be triggered by a joint resolution) and prompt suspension of the investment tax credit. It then strongly supported the idea of an active fiscal policy, with particular emphasis on raising and lowering taxes. In view of this history as well as its special responsibility for advising Congress on economic policies under the Employment Act of 1946, the Committee's defection from the "new economics" banner is a matter of more than passing importance.

Contrasting Views on "Fine Tuning"

The differences between the "new economics" doctrine and opposing views were effectively revealed by expert testimony at the Committee hearings. A leading exponent of "fine tuning" was Professor Walter W. Heller of Minnesota, who initiated the "new economics" era in 1961 as chief economic adviser in the Kennedy-Johnson Administration:

Quick and fine tuning of economic policy must be the order of the year in which we expect first an ebb and then a flow in the tides of economic advance, all the while operating near full employment, with continued cost-push inflation. In this context, the case for a midyear effective date for the proposed 6 per cent temporary surtax is clear.

In line with his "fine tuning" stand, Mr. Heller maintained that the surtax should be increased or decreased in size and postponed or dropped completely depending on economic conditions. He went on to call for "push-button tax increases or decreases activated by the President and subject to congressional veto."

But many economists have come to reject the economic thinking behind "fine tuning," which assumes that the private economy is highly unstable and subject to manic-depressive behavior unless constantly corrected by Government action. While recognizing that the "new economics" has represented an advance in fiscal-policy thinking insofar as it is based on the con-

cept of a "high-employment surplus," these observers have become highly critical of its basic assumptions about the economy.

In the first place, they reject the view that the economy is so unstable as to require constant "fine tuning" through fiscal and monetary policy. Among the critics of this view before the JEC was Professor Paul McCracken of Michigan, former economic adviser in the Eisenhower Administration, who pointed out that "a far larger part of our problem of economic instability has come from erratic and inappropriate fiscal and monetary policy than we may like to admit."

While the news media have widely acclaimed the "new economics" for its role in maintaining economic expansion, Mr. McCracken and other witnesses submitted considerable evidence indicating that fiscal policy actions had been poorly timed in recent years. Moreover, far from exerting an exquisite and unflinching control over economic activity, fiscal policy was shown to be less effective than monetary policy. The "new economics" school, on the other hand, have usually regarded monetary policy as no more than a handmaiden to fiscal policy.

Professor John Culbertson of Wisconsin downgraded the role of fiscal policy in the recent expansion period in the following words:

The recovery from that [1960-61] recession occurred despite the fact that fiscal policy remained unusually restrictive. Fiscal policy moved to a less restrictive position in 1962, which will be recalled as the year when the economy developed an increasingly slack position. Despite the condition of the economy, fiscal policy moved back to an unusually restrictive position in 1963. But despite this, the economy in early 1963 began the upsurge in total demand that finally brought back full employment.

He pointed out that fiscal policy became unusually expansive only after mid-1965 when full employment had been substantially achieved, and then became even more expansive in late 1966 and early 1967. Despite the most expansive fiscal policy of modern experience, he went on, the economy over the past year "has been transformed from extreme expansion to the brink of recession."

Advocates of an active fiscal policy argue that its effectiveness has been hampered by slowness in congressional decision-making. They maintain that policies could be improved by adopting "push-button" taxes legislated in advance and activated by the President as needed. The chief difficulty, however, is that an appropriate fiscal policy requires a high degree of accuracy in economic forecasting and an early recognition that action is needed.

In late 1965 and early 1966, the Administration failed to recognize the intensity of the boom

then under way and underestimated the amount of restraint needed. And when it finally acted to suspend the investment tax credit last September, the capital spending boom had already crested, as the current and subsequent surveys confirmed. It has now acted to restore the credit at a time when the business slowdown may weaken capital spending to the point where the credit may be insufficient to bring a real revival.

Emphasis on Monetary Factors

Many economists have also been critical about the timing of monetary policy changes. At the same time, belief in the key influence of monetary policy has been growing. Among the witnesses upholding this view was Beryl Sprinkel, Vice President of the Harris Trust and Savings Bank, who presented the following appraisal:

Although fiscal policy received most of the plaudits for the 1961-65 economic expansion, it should be noted that economic performance can be better explained by trends in monetary growth. Despite the fact that the 1964 tax [cut] lagged the initial proposal over 1½ years, the economy continued to record favorable growth records in response to an expansive monetary policy following the 1962 slow-up. Furthermore, there was no demonstrable acceleration in the economy subsequent to the tax cut.

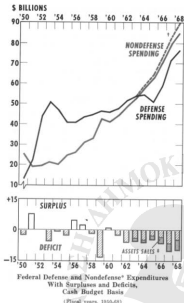
Rather than looking on monetary-fiscal policies as substitutes, the evidence suggests they are more nearly complements with monetary policy providing the major spending motive force while the tax system establishes the structural incentives to encourage production, employment, savings, investment, and growth.

Many economists also attribute the recent business slowdown to the abrupt change in money supply behavior from an excessive rate of expansion to an actual contraction in the spring of 1966. As Mr. Culbertson pointed out:

Money growth from the spring of 1965 through the spring of 1966 was by far the most rapid during any period of prosperity in recent times. . . . Finally, with characteristic abruptness, the rate of growth of the money supply changed again in the spring of 1966, now becoming sharply restrictive by involving a net decline in the money supply, compared with an average earlier performance of 3 or 4 per cent a year growth.

Evidently, this sharp departure in monetary policy can be interpreted as the factor causing the choking off of expansion since last summer.

The recent experience, therefore, provides added evidence of the crucial role played by money supply behavior. Economists in recent years have accumulated a great deal of evidence confirming the importance of monetary factors in the economy. The revival of interest in monetary behavior, as evidenced by the JEC hearings, is largely attributable to the researches of Pro-



Federal Defense and Nondefense* Expenditures
 With Surpluses and Deficits,
 Cash Budget Basis
 (Fiscal years, 1950-68)

*Excluding interest payments to the public. (Dashed line shows actual nondefense spending, excluding credits from sales of financial assets (since fiscal '63), and '67 and '68 plotlines for defense and nondefense spending otherwise reflect January budget projections. †Sales of financial assets (since fiscal '63).

fessor Milton Friedman of Chicago, whose monumental study (with Anna Schwartz), *A Monetary History of the United States, 1867-1960*, has had a wide-ranging impact on economic thinking.

New Role for Fiscal Policy

The accumulating evidence on the key role of monetary factors in the economy obviously has important implications for fiscal policy. For if monetary policy largely determines the course of economic activity, this reduces the need for an active fiscal policy, particularly one that would require Congress to hand over much of its power over taxation to the Executive branch.

The JEC's call for a \$5-6 billion cut in fiscal 1968 expenditures and its rejection of any early action on the tax surcharge conforms with the new views that are emerging among economists.

As Mr. McCracken pointed out, "a fairly wide range of budget positions" may be consistent with a given level of GNP. But the budget remains important because the size of the budget deficit (including sales of financial assets) "has a powerful effect on capital markets and the level of interest rates." Mr. McCracken, therefore, suggested a new division of labor between monetary and fiscal policy:

We now see it as the task of monetary policy to set the growth path for the domestic economy, and it is the task of fiscal policy to achieve the money and capital market conditions that will validate this course.

Many people who favor a tax increase to narrow the prospective 1968 budget deficit apparently are unaware of the accelerated growth of nondefense outlays, which has been partly hidden by offsetting sales of Federal financial assets. But as the accompanying chart shows, nondefense spending is climbing much faster than defense outlays.

The presumed success of the "new economics," particularly as exemplified by the 1964 tax cuts, is often regarded as setting a precedent for a flexible fiscal policy, whereby Federal spending and tax rates would be continuously adjusted to economic conditions. But Congress's intent in lowering tax rates at that time was to stimulate the economy by improving incentives and equity. Indeed, the preamble of the Revenue Act of 1964 specifically called for "all reasonable means to restrain Government spending."

Because the Joint Economic Committee has a special responsibility for economic stabilization, its current policy stand against "push-button" taxes and excessive tax changes is a welcome development. A similar posture had already been taken by Chairman Wilbur Mills of the House Ways and Means Committee, which has jurisdiction over initiating tax legislation. In a speech delivered last February, Mr. Mills said:

We must not let ourselves be put into the position of raising or lowering the headlines of taxation from season to season merely to make the merchandise more salable.

It is increasingly obvious that the 6 per cent surtax proposal is not only ill-timed and inappropriate under present conditions, but it represents a psychological barrier to business confidence. Instead, sound fiscal policy requires a slowing in the explosive growth of Federal spending. Pruning \$5-6 billion from proposed expenditures, as suggested by the Joint Economic Committee, would put the economy in better shape to resume healthy growth.

Meanwhile, easier money should be our main

instrument for stimulating a further advance in business. Our recent experience, however, suggests that a steadier monetary policy—one that avoids excessive swings up and down—is a vital

The European Common Market After Ten Years

The European Common Market is marking the tenth anniversary of the Treaty of Rome which, on March 25, 1957, laid its foundations. The treaty's basic goal will be fulfilled in July 1968 when the Common Market will become a customs union—with tariffs on internally traded industrial as well as agricultural goods abolished. At the same time, however, obstacles—many of them sensitive, obstinate and charged with political overtones—lie in the way of almost any approach toward a more fully integrated economic union among the six member nations of the European Economic Community.

Furthermore, great and vital issues overhanging the future of Europe and its economic and financial relationships with other parts of the world will have to be resolved in the coming months. Most important among these issues are the membership of the United Kingdom in the Common Market and the round of tariff bargaining, now in its final phase, to expand international trade on a multilateral and nondiscriminatory basis through reciprocal reductions in tariffs and other barriers.

Clipping the Customs Union

The EEC over the past nine months has recovered from the most serious crisis in its existence—a crisis which began in July 1965 when France, the largest agricultural producer among the Six, insisted that no common market would be possible if it did not include agricultural goods. This objective was specified in the Treaty of Rome but was left open for future negotiations.

Following protracted negotiations, the Community agreed last year on a common agricultural policy to be in full operation by mid-1968. Its principal features are that trade in agricultural products among member nations is to be freed from restrictions and that, to encourage greater domestic output and self-sufficiency, prices are to be maintained—at levels substantially higher than world prices—by levies or tariffs on imports and by support purchases.

The common policy requires financing to support domestic prices, modernize agriculture and subsidize farm exports for the world market. The cost of financing—as now agreed for the period up to the end of 1969—is to be met partly from the proceeds of import levies and partly from

necessity if the economy is to maintain non-inflationary growth. In easing money now, therefore, care should be taken to stay within the safe speed limits for monetary expansion.

contributions of member governments.

The crisis over the common agricultural policy took its toll by delaying for a year the deadline for establishing a full customs union; but on July 1, 1968, the remaining 15 per cent of tariffs on internally traded industrial goods and the last 35-40 per cent of tariffs on internally traded agricultural goods will be abolished—eighteen months ahead of the schedule provided for in the Treaty of Rome. Another notable achievement of the Common Market is the establishment of practically complete freedom of movement of workers and their families.

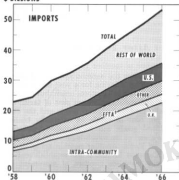
A Somber Touch

A somber touch to this bright picture is the slow progress being made toward ironing out issues that hamper the Common Market from advancing beyond the stage of a mere customs union. Thus, there has been very little progress toward harmonizing customs procedures and devising a common patent law, antidumping regulations, a "European company" law, a common energy policy and a common transport policy. The establishment of a common capital market is proving very difficult so long as there are different standards in each national market. Yet another task is the easing of the remaining exchange controls, including the suppression of all types of discrimination between nationals and nonnationals in such matters as issuing stocks and bonds.

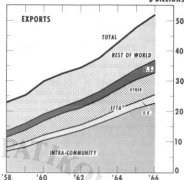
An encouraging development is the first step toward the removal of fiscal frontiers, taken in February 1967, when agreement was reached on the harmonization of turnover taxes. By 1970, a single tax on the value added at each stage of manufacture and distribution will replace the "cascades" of taxes used in Belgium, Germany, Italy, Luxembourg and the Netherlands; the present "value added tax" in France is to be aligned with the Community's system.

Almost simultaneously with staking out the shape of "fiscal Europe," the Common Market has adopted its first medium-term economic policy program for 1966-1970. This is a significant development since, for the first time, the Six have agreed to compare their respective economic plans and policies, to review them and to try to coordinate them on a permanent basis.

\$ BILLIONS



\$ BILLIONS



Foreign Trade of the European Economic Community*

* Belgium, France, the Federal Republic of Germany, Italy, Luxembourg and the Netherlands. † Austria, Denmark, Norway, Portugal, Sweden, Switzerland and the United Kingdom.

Note: Data for 1966 are annual rates for January-November.

Membership in the Community tends to strengthen the healthy compulsion to pursue policies of monetary stability. For, as experience has confirmed, in an economic community there is a rapid and widespread transmission of inflationary pressures and balance-of-payments disturbances from one country to its partners.

Yet, fiscal and monetary policies cannot be easily harmonized. To show the length of the road the Common Market will have to cover, it is perhaps enough to recall that even the three countries that in 1948 established Benelux—the customs union among Belgium, the Netherlands and Luxembourg—still have separate fiscal and monetary policies.

Looking Inward or Outward?

The Common Market is establishing a common tariff wall against the rest of the world, effective July 1, 1968, and, ultimately, a unified commercial policy. Thus far, it has eliminated 60 per cent of the differences between national tariffs toward nonmember countries. Removing tariffs within a closed area helps insiders but puts outsiders at a disadvantage. Outsiders are naturally concerned with the growth of new tariff discrimination that may hurt their markets in the Community for agricultural products, industrial materials and manufactures.

There is no simple way of determining whether the Market is inward- or outward-looking.

protectionist or liberal. One way is to consider the Community's external tariff as it is taking shape—to lie, broadly speaking, between the higher tariffs of France and Italy and the lower tariffs of Germany and Benelux. Since Germany and Benelux are particularly large importers from outside the Common Market, the new common tariff clearly implies a disadvantage to outsiders. At the same time, the Common Market tariff, by its very nature, is rather homogeneous, showing fewer peaks and valleys, and, especially, fewer duties of over 25 per cent, than the U.S. tariff, though the latter also includes a substantial number of zero or low duties. These tariff disparities are among the ticklish problems now being dealt with in world trade talks.

A better way may well be to look at actual trade, as in the chart. Trade within the Common Market has grown extraordinarily. Thus, in 1966, intra-Community imports reached \$23 billion, more than three times as high as in 1958.

The Common Market, the world's largest importer, has also substantially expanded its purchases from outsiders. Last year, such imports totaled \$31 billion—almost twice the 1958 figure.

As to the United States, somewhat less than one fifth of our exports go to the Common Market—\$5.3 billion in 1966, twice as much as in 1958. In view of the importance of agricultural products, it may be noted that U.S. agricultural exports to the Common Market, our largest market accounting for nearly one fourth of such

U.S. exports, increased to \$1.6 billion in 1966 or 90 per cent above 1958; the major part of the increase was in feed grains. The United States seeks assurances that its agricultural exports will gradually expand as the Common Market's consumption grows.

The Common Market buys more from the United States than it sells here. In 1966, the U.S. export surplus amounted to \$1.2 billion. This has helped to reduce our large payments deficit with the Common Market stemming from defense outlays and capital investments.

During the formative years of the Common Market, the United States openly and consistently aided efforts toward European integration, partly for reasons of international security, partly in the expectation that the rapidly expanding market of some 185 million people, nearly as many as in the United States, would lead to increased demands for the products of other parts of the world and would thus help expand world trade all around. Living by trade, the Common Market nations are export-minded and know that trade is a two-way street.

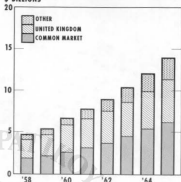
Common Stakes in Bricks and Mortar

The strength and the promise of the Common Market, together with the desire to establish plants within its boundaries, have provided a powerful impetus to U.S. private direct investment. During the seven-year period 1959-1965 (no statistics are as yet available for 1966), U.S. private direct investments in the Common Market rose from \$1.9 billion to \$6.3 billion.

This process is not new, since many U.S. enterprises have been in what is now the Common Market for a long time and are fully integrated with the respective national economies. The share of U.S. firms in total new investment in plant and equipment remains small; for the Common Market as a whole, the proportion works out at about 5 per cent a year.

The growth of U.S. direct investments in the Common Market has been fed mostly by new capital from the United States. Of late, these flows have slowed, as noted in these pages last month. The decline is, in part, the result of business compliance with the U.S. Government balance-of-payments programs. But the great surge in investment has also tapered off on its own because of lower profits. The rate of return on European manufacturing investments of U.S. firms, which prior to 1962 exceeded the domestic

\$ BILLIONS



U.S. Private Direct Investments in Europe*

* U.S. private direct investments abroad are the U.S.-owned portions of foreign businesses in which U.S. residents have managerial interest. The value is measured by the original investment of U.S. capital plus additions through reinvested earnings, transfers of new funds and extensions of credit to the parent company.

profit rate, has over the past two years turned downward and is now below the U.S. rate.

The Common Market's medium-term economic program, mentioned earlier, anticipates a "real" rate of growth for the Community of the order of 4.3 per cent a year—a rate distinctly slower than the 4.9 per cent annual growth rate during 1960-1965. This is the consequence of the present high degree of utilization of available economic resources and, particularly in Germany, of the small increases in working population. The program assumes an annual rise in productivity per worker of 3.8 per cent so that productivity would be doubled in less than twenty years; this in turn requires a continued expansion of productive investment.

The Common Market will, therefore, need more capital, especially if rising wage costs are to be offset by greater productivity and economic efficiency. At the same time, so far ahead as can be seen, markets may well be less buoyant, competition more severe, and profits harder to achieve. These changing prospects, while in no way detracting from the fundamental attractiveness of the Common Market, may lead foreign investors to assess each new project on its own merits even more exactly than in recent years.

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