

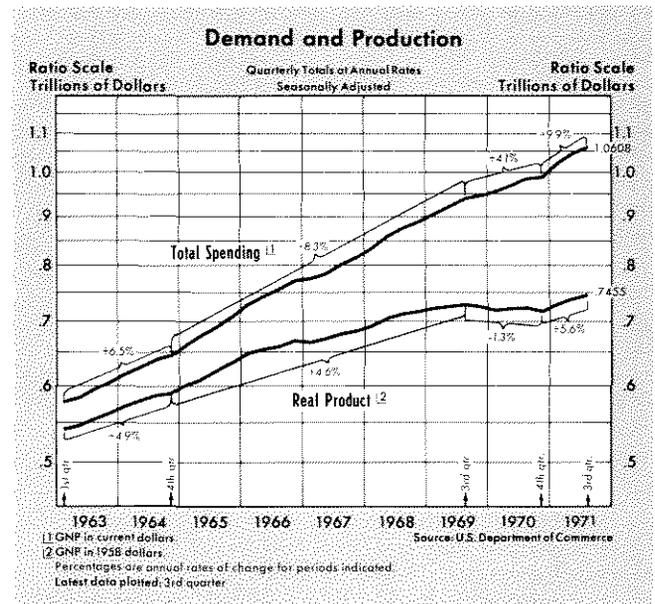
# 1971-Year of Recovery and Controls

by NORMAN N. BOWSHER

THE YEAR 1971 was one of economic recovery from the 1969-70 recession and moderate progress in the battle against inflation. Yet, because these improvements were less than deemed attainable, the country turned to a new economic stabilization program in which centralized controls played a dominant role.

Most measures of activity reflect a pronounced improvement from the recession and strike-depressed conditions of late 1970. Total spending on goods and services has risen about 9 percent during 1971, up from both the 4.3 percent increase during 1970 and a growth trend of 6.3 percent from 1957 to 1970. Real output expanded about 5 percent in the year, after declining slightly in 1970 and rising at a 3.7 percent trend rate from 1957 to 1970. Some improvement was also made with respect to inflation even before imposition of the freeze. Overall prices, as measured by the GNP deflator, rose at a 4.7 percent annual rate in the first half of 1971, down from the 5.7 percent increase in 1970. This was the first significant reduction in the pace of inflation since it began in 1965.

Despite the economic gains, which were roughly in line with most projections at the beginning of the year, the performance of the economy was generally considered unsatisfactory. The public had been led to expect more employment and a slower pace of inflation. The President's Economic Report at the beginning of the year projected much sharper rises in spending and production as well as more improvement with respect to inflation than actually occurred. The financial press often compared current performance with goals of full employment and relatively stable prices, without regard to their attainability in the short run. Unemployment, averaging 6 percent of the labor force, was especially disturbing in this context.



In view of the high aspirations for the economy in such a short time period, frustration over the trend of developments became widespread. Many were led to believe that fiscal and monetary actions had become largely impotent in the face of the power of big businesses and major labor unions to administer prices and wages. Institutional relationships seemed to have undergone a major transformation, especially to those who had advocated the tolerance of inflation in order to assure high employment.

Because of the slow progress in real economic expansion and the continued inflation, as well as a deteriorating balance-of-payments situation, the nation adopted a new economic program in mid-August. Among other things, the program was designed to directly control increases in prices and wages.

Largely overlooked in the analysis of 1971 was the influence of trends of activity and stabilization actions taken in the immediately preceding years. These elements go a long way toward explaining the alleged failure of traditional stabilization actions to stimulate employment and reduce the pace of inflation. In this review of the year 1971, discussion is first devoted to these earlier developments. Particular emphasis is placed on the inflation problem since it had been developing for a relatively long period, and since both the underutilization of resources and the imposition of wage and price controls are related to attempts to resist this inflation. Finally, after examining economic developments of 1971, the outlook for 1972 is discussed.

### The Problem: Inflation

A major economic problem of 1971 has been the persistence of a strong inflation. Inflation is a rise in the average level of prices of goods and services. As the prices of goods and services rise, the purchasing power of money, bonds, savings accounts and other money-denominated assets falls. An unanticipated change in relative values of money denominated assets and other assets causes unplanned wealth transfers.

#### *The Wealth Transfer Effects of Inflation*

Losses, and offsetting gains, caused by an unexpected change in prices can be illustrated by reviewing the experience of bond holders. A buyer of a typical 20-year highest grade corporate bond in early 1965 received a coupon yield of about 4.5 percent per year. Since overall prices had risen on average at less than 1.5 percent per year for about eight years previous to that time, the buyer of the bond could reasonably expect a 3 percent real return on his investment (4.5 percent coupon reduced by about a 1.5 percent rise in prices). Inflation, however, turned out to be much greater than buyers of bonds anticipated. Assuming the bond was sold after five years (that is, in early 1970), the experienced real return turned out to be a *negative* 4 percent per year. Not only did the returned principal and interest buy less in 1970 than in 1965, but because the market in 1970 was expecting a greater future inflation, the required higher nominal return to get the desired real return caused the dollar price of the bond to fall about 25 percent. The issuers of bonds, on the other hand, receive a great windfall when repayment is made in depreciated dollars.

An individual who retired on a pension or bought a life annuity in 1965 found that the income received in mid-1971 would buy only 77 percent as much as in 1965. Based on the 1958 to 1965 experience, he might

have expected in 1965 that the purchasing power would be about 91 percent in 1971. Elderly people dependent on pensions or annuity income are at a particular disadvantage during a period of accelerating inflation. Opportunities for them to hedge against the inflation are few, and those available may present additional financial risk.

The current inflation is likely to have redistribution effects on real income and wealth for a long time. Considerable experience is necessary to make relatively accurate forecasts of future inflation. For everyone to correctly anticipate inflation and make the proper hedge in all contracts and other dealings is virtually impossible.

#### *Course and Causes of Inflation*

From 1958 through 1964, there was little inflation in this country. After 1964, the rate of increase in prices gradually accelerated until late 1969 and early 1970, when overall price rises crested at a 5.8 percent annual rate. From the first to the fourth quarter of 1970 prices increased at a 5.4 percent rate, and in 1971, before the freeze, prices rose at a 4.7 percent rate. Since the freeze was announced in mid-August, prices have risen less rapidly than they did earlier in the year.

**Market power.** Some attribute the inflation to the ability of unions and other sellers of productive resources to make effective exorbitant demands. It is asserted that businesses, also with some power to administer prices, seem reluctant to resist such demands, passing on the rising costs with a mark-up in prices to the consumer. A spiral is generated as labor seeks still higher wages to compensate for rising living costs. This market power explanation of inflation appeals to many observers, although labor and management naturally disagree as to which group triggered the spiral.

To be consistent with recent inflationary experience, the market power explanation of the recent inflation assumes that resource owners gradually became more powerful from 1964 to early 1970, and have since become less powerful. This is unlikely, but in addition, market power as an explanation of a large overall price increase is incomplete. Admittedly, some unions and businesses have power to raise their wages or prices considerably above the competitive equilibrium levels. However, as long as total spending remains unchanged, the higher prices for some items indicates either offsetting lower prices for some others, or what is more likely in view of the downward rigidity of many prices, lower sales, production, and employment. Hence, market power or cost-push, unless accompanied by greater total spending, is a better explana-

tion of unemployment and idle plants than it is of inflation.

**Demand-pull.** Another explanation of inflation concentrates on excessive total spending; that is, "too many dollars chasing too few goods." Yet, do businessmen readily raise prices as soon as the demand for their products strengthens, as in the case when goods are auctioned? Most businesses will sell all the merchandise available at the going price. Mark-ups typically occur when wages are increased or when costs of goods sold rise. Critics of this view point out that if higher prices are a response to excessive demand, why has there been a continued rise in overall prices since early 1970 when some workers and factories have remained idle?

The demand-pull effect on prices from excessive spending is not immediate, however, as illustrated by examining pricing policies in a fictitious "widget" line. As consumers spend more on widgets, as well as on other goods and services, retailers are willing to reduce their inventories temporarily at going prices, since their knowledge of demand and supply schedules is imperfect and cannot be quickly improved at a reasonable cost. Orders are placed with wholesalers for more widgets, who in turn, reduce their stocks usually without a price markup. Wholesalers increase their orders with manufacturers, and more widgets are produced at going prices. However, once production orders rise to the point where the cost of resources is bid up in order to fill these requests, costs of producing widgets increase. These costs then are passed back up the line, not only directly in the form of higher widget prices, but also indirectly through the entire economy by bidding up the prices of labor, materials, and land.

This illustration of the inflation process, which treats excessive demand as the key determinant, may explain why many business firms believe inflation begins with a rise in costs. Also, since information on changes in production costs and demand schedules is imperfect and expensive to improve in the short run, the rate of price increase may accelerate only slowly at first, even under intense total demand and product shortages. Conversely, prices are likely to continue working up long after the excessive demand pressure is removed and slack develops in the production process. Time lags between changes in demand and in prices are, of course, lengthened with monopolistic power and long-term contracts. The phenomenon known as cost-push inflation is usually the latter stages of a demand-induced inflation. The time lag reflects the high costs of moving to equilibrium prices more rapidly.

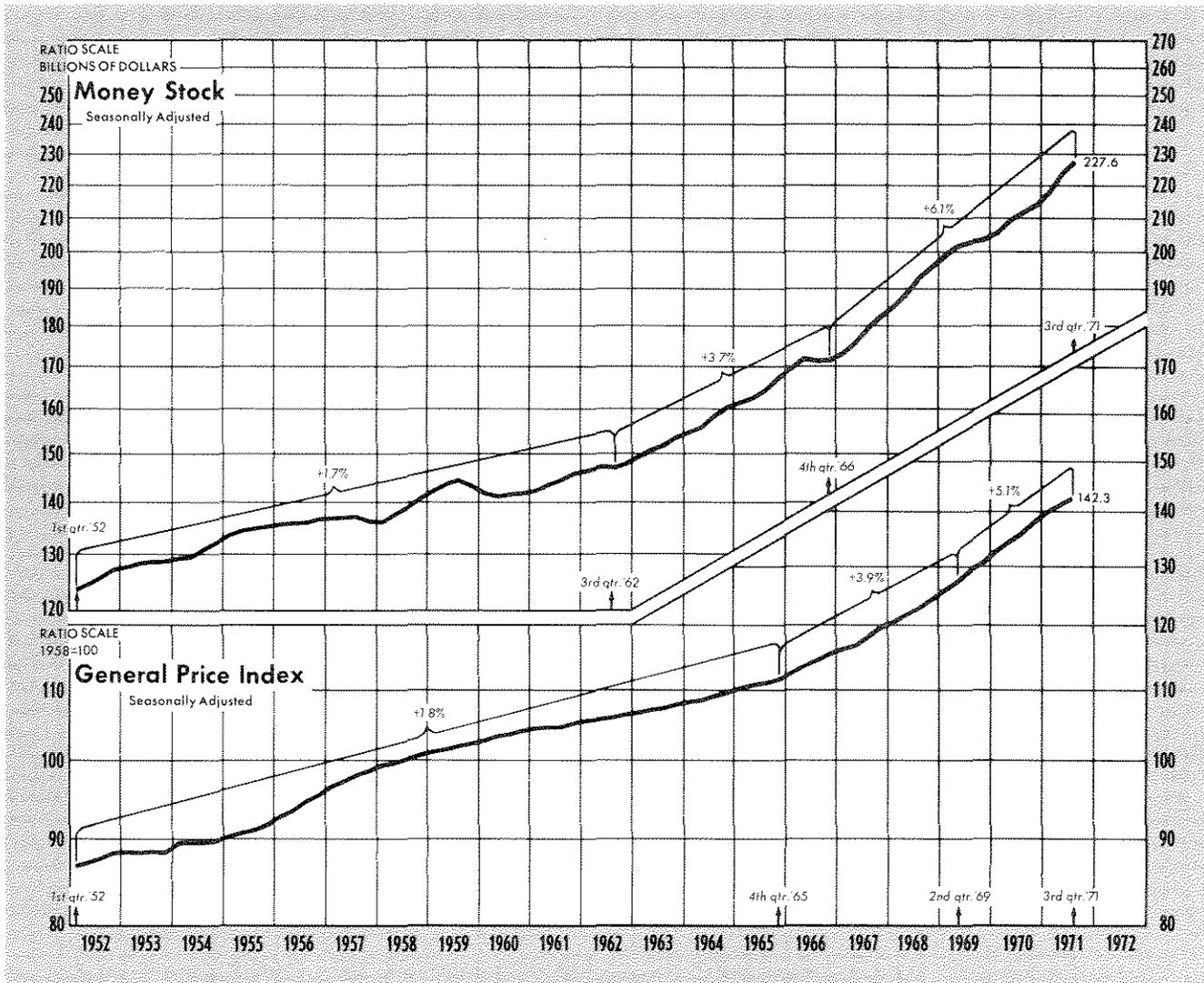
### *Contributions to Excessive Total Spending*

Total spending on goods and services rose at a rate roughly double the pace of productive capacity from late 1964 to the fall of 1969. What caused spending to rise so rapidly in this period? In our free enterprise system, each household and business firm has the choice to spend or save the funds received. Hence, the rise in total spending might be viewed as a bunching of a great many expansionary decisions. More spending units made greater outlays than ever before.

What was the causal force behind the surge in spending in the 1964-69 period? Analysts generally focus on fiscal actions (taxing and spending decisions by the Federal Government) and monetary actions (managing the nation's money supply). These actions, which are believed to influence total spending, are under control of public policy and can be managed.

**Fiscal actions.** Fiscal actions of the Government may not have much enduring effect on changes in total spending. Empirical studies at this Bank using standard measures of fiscal actions have indicated little lasting influence of moderate changes in Government expenditures on the trends of total spending, but sharply accelerating Government outlays may have important short-run effects. Deficits created by cuts in tax rates or increases in Government outlays must be financed by an expansion in Government debt. Such borrowing has tended to cause offsetting movements in private spending (unless accompanied by a change in the money stock). Government fiscal actions may affect income distribution and real growth rates, but have a relatively minor affect on the time path of total spending. Fiscal actions were a factor, but they alone should not be credited for causing the large and prolonged burst of spending in the 1964-69 period.

Government outlays increased rapidly in 1965 and 1966 in response to both the build-up for Vietnam and an expansion in nondefense expenditures. The large spending for these activities may have had some direct effect on the initial rise in total spending in 1965 and 1966. The potency of Government spending in affecting total spending, however, was seriously questioned when in late 1966 and early 1967 total spending hesitated, even though fiscal actions were the most expansive in over a decade. A second test came in late 1968. As a result of the 10 percent surtax and cutbacks in the growth of Federal spending, a marked slowdown in total spending was forecast for late 1968 or early 1969. Yet, spending continued to rise rapidly, and the pace of inflation intensified.



**Monetary actions.** A marked variation in the rate of change in money from a previous trend which is sustained for several quarters, by contrast, has almost always been followed by a similar change in the growth of total spending.<sup>1</sup> The trend growth of money has apparently been a major force in the trend of overall prices.

Money stock rose at a 5.2 percent annual rate from mid-1964 to April 1966, after rising at a 2 percent trend rate from 1957 to 1964. The greater Treasury borrowing plus a reluctance to permit sharp upward movements in interest rates probably contributed

greatly to the faster money growth. After a brief time lag, total spending on goods and services also accelerated. Money remained on a plateau from April 1966 to early 1967, and with a similar lag, there was a brief pause in the upward thrust of total spending from late 1966 to mid-1967, called the mini-recession. From early 1967 to early 1969 money again rose at a very rapid 7.6 percent rate, and from mid-1967 to the fall of 1969 total spending rose correspondingly, and inflation intensified.

*Stabilization Actions in 1969 and 1970*

In an attempt to reduce the inflationary upsurge, both fiscal and monetary actions became less expansionary in 1969. Reflecting the effects of the Revenue and Expenditure Control Act of mid-1968, which included a 10 percent surtax and cuts in Federal spending, the high-employment budget moved from a deficit of \$7 billion in 1968 to a surplus of \$11 billion in 1969.

<sup>1</sup>In "Money Supply and Time Deposits, 1914-69," this *Review* (March 1970), pp. 6-10, money growth rates and cyclical movements in economic activity, as determined by the National Bureau of Economic Research, were compared. The record clearly indicates that marked and sustained changes in the rates of growth of money were usually followed after a brief lag by cyclical movements in business activity in the same direction.

Growth in the money stock was slowed from the 7.6 percent rate of the previous two years to a 3 percent rate from early 1969 to early 1970, approximately equal to the trend since 1957. Control of monetary expansion was facilitated by the reduced financing demands of the Treasury.

Beginning in the fall of 1969, or about six months after the reduction in the growth rate of money, growth in total spending slowed from the excessive 8.3 percent rate to a more moderate 4.1 percent pace, a rate approximating the growth in productive capacity. Despite the moderation of total spending growth, the upward surge of prices continued to accelerate in 1969, probably as a lagged result of earlier excessive spending. Effective real demand slowed, and real production remained almost unchanged in late 1969.

Early in 1970 the traditional policies of economic stabilization became more expansive. Fiscal actions became slightly more stimulative as the Tax Reform Act of 1969 reduced personal tax liabilities on balance. The surplus in the high-employment budget declined from \$11 billion in 1969 to \$7 billion in 1970. From February 1970 to January 1971, the money stock rose at a 5.5 percent annual rate. Historically, this was a rapid rate. During the Fifties and early Sixties, such a growth of money, if long maintained, tended to cause accelerating inflation. However, with strong inflationary expectations in 1970, which could not be quickly eliminated, spending could be permitted to expand faster than the growth of productive capacity and still place some downward pressure on prices. By temporarily permitting a faster growth in total spending, transition costs in terms of unemployment and lost production were expected to be kept at more moderate levels.

Growth in total outlays on goods and services remained moderate during 1970. In the first half of the year, spending was probably greatly affected by the slower rate of monetary expansion in 1969. In the second half of 1970, expansive effects of the more rapid monetary expansion in the year were temporarily thwarted by cutbacks in the production of war goods and by a large strike in the automobile industry.

The peak of the inflation was reached in early 1970, and the rate of price advance began a very slow retreat. The moderate growth in spending and a continued rapid rate of price advance combined to cause some cutbacks in total real output. The period from late 1969 to late 1970 was labelled a recession, but even with interruptions to production induced by a large strike, it was one of the mildest on record. Late in 1970 activity began expanding, and as 1971 began,

the country was in the initial stage of an economic recovery.

## Situation Prior to the Freeze

### *Business Conditions*

Both fiscal and monetary developments had stimulative effects on business activity during the first seven and a half months of 1971. The high-employment budget, which measures discretionary fiscal actions, remained near the \$7 billion surplus rate of the previous year. However, because Government receipts and expenditures are also greatly affected by cyclical changes in the economy, the Government may have had expansive "automatic stabilizer" effects. Economic activity was depressed in late 1969 and early 1970, and tax revenue declined markedly. The deficit in the national income accounts budget went from \$14 billion in 1970 to nearly a \$20 billion rate in the first half of 1971. This larger deficit also increased Treasury financing demands, making control of the money stock more difficult, especially in the late spring and summer when market interest rates were rising.

Monetary developments also had an expansive impact on spending during the first seven and a half months of 1971. Since monetary actions have usually affected economic activity with a lag distributed over about five quarters, most of the monetary effect on business activity in early 1971 probably resulted from the moderately expansive actions taken in 1970. The rapid monetary expansion of early 1971 contributed further to spending decisions in that period.

In addition, spending in early 1971 was greatly bolstered by several special factors. During the automobile strike in late 1970 many outlays were delayed and after the strike a great rebound in spending occurred. Also, in early 1971 purchases of steel were reportedly increased in anticipation of a possible strike in the summer of 1971.

Total outlays on goods and services rose at about an 11 percent annual rate from late 1970 to mid-1971. By comparison, spending had risen at a 4.1 percent rate in the previous five quarters and at a 6.3 percent trend rate from 1957 to 1970. Retail sales rose at a 10.6 percent rate from December 1970 to July, after going up at a 2 percent rate in the previous two years. The rise in spending in early 1971 was sizable, but because of the non-recurring strike situations, the data exaggerate the strength of the underlying spending trend.

Despite the pronounced expansion in spending in the first half of 1971, economic activity seemed to be

sluggish and improving only slightly. The momentum of inflation eroded only gradually, and continued to absorb much of the rise in spending. Prices rose at a 4.7 percent rate in the first half of 1971, compared with 5.7 percent in 1970. Although this was the first marked decrease in the pace of inflation since the surge began in 1965, the continued inflation was a great disappointment to those expecting rapid improvement with the economic slack.

Then, too, the spending increases in early 1971 began from a very low level caused by both the recession and a major strike. Real output rose at a 6.4 percent annual rate in the first half of 1971, after declining slightly in the previous five quarters and increasing at a 3.7 percent trend rate from 1957 to 1970. As is usually the case after a period of depressed activity, the initial rise in output, although large, was accomplished primarily by more extensive use of the existing employed workers and facilities. Industrial production responded less to the rise in total spending than other types of output. During the summer there were reductions of steel inventories which were previously built-up as a hedge against a strike. Imports of goods from foreign producers increased rapidly in the first seven months of 1971, and accounted for a larger share of total sales.

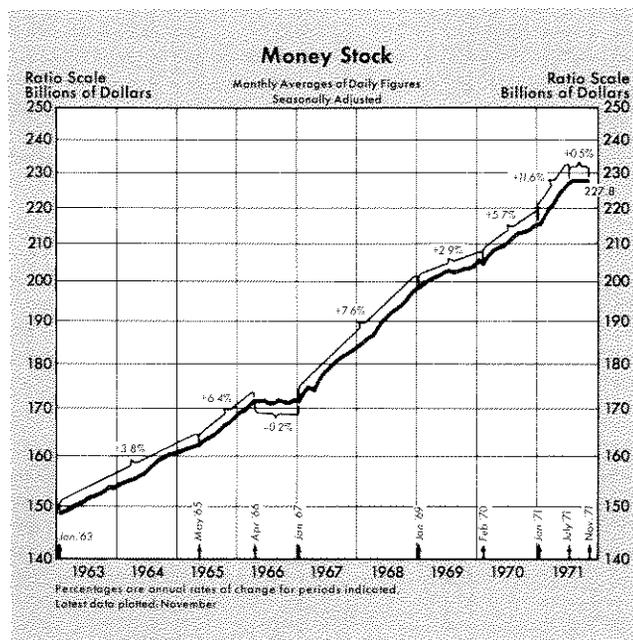
The volume of idle resources, which was relatively large, changed little during the pre-freeze period of 1971. Unemployment continued at about 6 percent of the labor force, although among married men it was only 3.2 percent.

### Monetary Actions

Early in 1971 the rate of monetary expansion accelerated again. From January 1971 to July of this year the money stock increased at an 11.6 percent annual rate, the fastest six month increase since World War II. By comparison, money increased 5.4 percent in 1970.

Federal Reserve credit, the monetary base, and member bank reserves also rose rapidly during the first seven months of 1971. For example, Federal Reserve credit, which measures the direct monetary actions of the Federal Reserve System, rose at about a 15 percent annual rate from December 1970 to July 1971, or about twice the rate in 1970 and about four times the rate in 1969.

The rapid monetary expansion in the first six months of 1971 reflected a combination of factors. Money growth had slowed in late 1970, and a catch-up increase was desired in the first quarter of 1971. The



trend rise in velocity of money appeared to be decelerating, suggesting that a somewhat faster growth of money stock would be desirable. Additional economic stimulation also seemed appropriate. Even though the 1969-70 recession had been halted and total spending was expanding rapidly, economic commentators focused chiefly on the idle plant capacity, unemployment, and the apparent lack of progress in reducing them. Inflation seemed less of a constraint on monetary stimulation since many believed that it would dissipate relatively fast in view of the potential competition from excess productive capacity. Interest rates rose rapidly from mid-March to July, the three-month Treasury bill going from 3.30 percent to about 5.40 percent, and a fear developed that more restrictive credit conditions might abort the fragile recovery. Finally, some of the increase late in the period was probably accidental. Precise monetary control is impossible in the very short run given the present institutional structure, especially when money market conditions are used as the operating indicator.

## The Freeze and the Period Following

### The Freeze

The imposition of a new economic stabilization program, commonly called the "freeze" occurred with a Presidential announcement on August 15, 1971. The time for action seemed appropriate. Concern over the persistent high level of unemployment and the lack of progress in reducing the stubborn inflation was intensified by projections of most econometric models that only moderate progress on either front would occur

during the next twelve months without dramatic action. Some felt that the power of strong unions and big businesses to administer prices had so changed the structure of the economy that traditional monetary and fiscal actions were ineffective, or at least operated too slowly.

Also, during the summer of 1971 business activity seemed to be in a lull, caused in part by strikes and reductions of excessive steel inventories, and some feared the economy might again move into a recession. Industrial production, which had risen at a 5.8 percent annual rate from December 1970 to May of this year, was unchanged in June and declined in both July and August. Payroll employment followed a similar pattern.

Timing of the announcement of the new program, however, was probably largely dictated by the international situation. The U.S. balance of payments with other nations had been deteriorating rapidly, and some prompt action became essential. The net liquidity deficit, which was about \$3.8 billion in 1970, rose to a \$10.2 billion annual rate in the first quarter of 1971, and further to a \$22.9 billion rate in the second quarter.

The economic program was a new, broad, and direct attack on the major economic ills facing the nation. Inflation was attacked by a 90-day freeze on wages and prices, followed by a less rigid program of controls in Phase II. Stimulus to the economy was to flow from proposed reductions in excise taxes on automobiles, increases in personal tax exemptions, and an investment tax credit. International problems were handled, at least temporarily, by "floating" the dollar and by imposition of a 10 percent surcharge on imports.

The new program relied heavily on direct controls over individual pricing decisions. This was a dramatic departure from the traditional approach of relying chiefly on monetary and fiscal actions for economic stabilization, which had left the terms of individual prices to market forces and the freedom to bargain by the parties involved. The imposition of controls caused distortions since some prices and wages had risen while others in similar circumstances had not. Lack of ability to pass on higher costs placed many firms in a squeeze, while some contracts for higher wages and prices were voided. Previous experience with controls had indicated that they misallocate resources, hamper economic growth, encourage quality deterioration, require increasing costs to administer, and may prove unenforceable, unless supported by sound fiscal and monetary actions.

Despite the known shortcomings of controls, they were welcomed by the general public. Consumers and

businesses, as well as the Government, sought quicker relief from the high level of unemployment and the continued rise in prices. The desire for a bold program that promised rapid improvement seemed to overwhelm the experience of previous control efforts. Most individuals were willing to give up some of their freedom as well as make personal financial sacrifices for the benefit of a better economy, as long as others were making similar sacrifices.

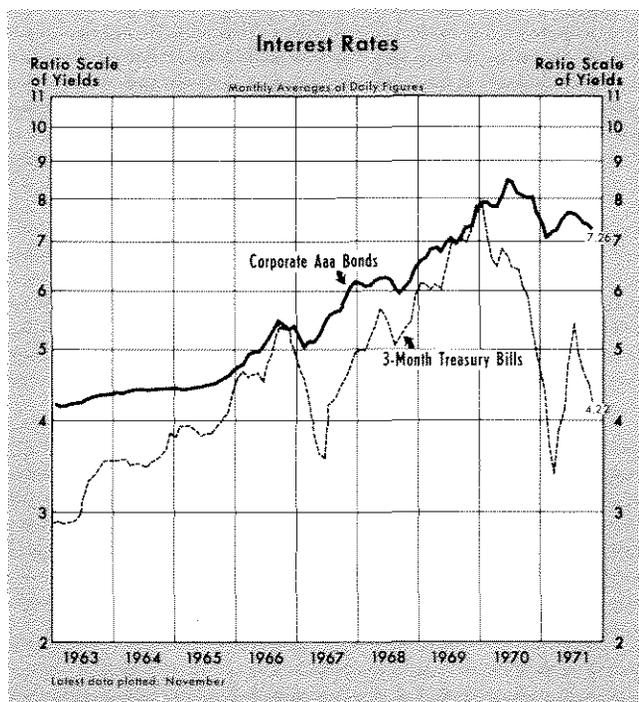
The current economic program has a better potential for success than most previous efforts at wage and price controls. Timing of imposition was much better than in previous efforts. Downward pressure on prices from excess capacity had existed for several years, and the rate of inflation was receding, although slowly. Unemployment was about to gradually erode in view of the recovery of spending and production. Also, with the relative slack, few shortages have developed, the usual cause of major problems in previous control efforts. In addition, recent monetary developments have aided the program by not adding to the underlying inflationary pressures.

Fiscal and monetary actions alone could have cured the inflation and unemployment problems, but, given the strong inflationary expectations, it might have taken several years. Controls may shorten the lags between sound stabilization actions and their effect on price expectations and employment. Also, Government controls could act as a countervailing power to some of the large monopolistic elements in society that tend to prolong the momentum of inflation and generate unemployment. To the extent that controls do slow price increases, more of the rise in spending will be focused on production and employment and less will be dissipated in higher prices.

### *Monetary Developments*

Since the imposition of the freeze in mid-August the money stock has changed little. A temporary pause in money growth was probably desirable in view of the rapid spurt during the spring and early summer. For the past twelve months, money has grown about 6.5 percent. This has been a rapid pace compared with a 5.4 percent increase in 1970, and a 3.1 percent rise in 1969. Federal Reserve credit, member bank reserves and the monetary base, which are the source of money creation, have shown similar patterns of expansion.

Because of changed conditions in the credit markets the slowing of money growth after mid-August was accomplished at a time of gradual reduction in market interest rates. The three-month Treasury bill rate de-



clined from about 5.25 percent in the first half of August to 4.15 percent in early December. Yields on highest grade seasoned corporate bonds decreased from 7.70 percent to 7.30 percent over the same period.

Both supplies and demands for funds changed substantially after mid-August. To the extent that borrowers and lenders expected the new program to reduce future inflation from what it might have been otherwise, the interest rate premium for expected inflation was lowered. A sizable foreign demand for Government securities developed, reflecting the large outflow of dollars from this country before the dollar was floated. Also businessmen probably became more cautious in expansion plans and credit demands during the fall of the year. Uncertainty was great over what rules would be adopted under Phase II of the New Economic Program and how these rules would be applied.

### *Business Conditions*

It is still too early to evaluate the impact of the freeze on economic activity. Few data are available since the imposition of the freeze, and the changed rules make interpretation more difficult than usual.

Apparently, total spending on goods and services has continued to expand at a relatively rapid rate since mid-August. Consumer outlays have been particularly strong, especially for automobiles, even though growth in income slowed with the freeze on wage increases. Business spending, which has been hampered by un-

certainities that the new program inevitably created, has probably continued to rise at a relatively moderate pace.

Production has also expanded since mid-August, but the rise has been less than the increase in sales. Industrial production rose at a 5.8 percent annual rate from the depressed August level to October. Reflecting the rise in output, payroll employment rose at a 2.2 percent rate from August to November.

Price developments since the imposition of the freeze have also been favorable. Prices of wholesale industrial commodities and wholesale farm products and processed foods and feeds declined from August to November, while consumer prices inched up at a much slower pace than earlier. However, the standard measures of prices probably overstate the amount of improvement, since they may not adequately reflect changes in quality or service.

### **Outlook**

As 1971 ends, the pace of inflation is slowing, and growth rates of production and employment are accelerating. Based on the momentum of business developments and stabilization actions taken in 1971, the outlook for 1972 is for continued progress in reducing inflation and increasing real output and employment. Developments in 1972, especially later in the year, will also be affected by stabilization actions taken in 1972.

Traditional monetary and fiscal actions will have a major impact on the course of economic developments in 1972. Empirical studies at this Bank indicate that monetary developments will have stronger effects than fiscal decisions, but sound monetary actions are facilitated by prudent fiscal programs.

Controls on wages and prices, may contribute to a downward adjustment of inflationary expectations, shortening the lags between the traditional actions and their economic impact. However, controls should be treated as supplementary to sound monetary and fiscal policies, and because controls encroach on freedom and reduce efficiency, it is desirable that they be phased out as quickly as possible.

Progress toward price stability and full employment is likely to accelerate in 1972. However, it serves no purpose to pretend that there is a quick, easy and costless cure to the economic disarray. The adverse consequences of the monetary and fiscal actions taken in financing the Vietnam War and the enlarged Government welfare and other nondefense programs in the 1965-68 period continue to weigh heavily on the

nation. Inflationary expectations were built up gradually during this period, as time after time great losses were experienced by those who failed to anticipate the inflation in their economic decisions. These experiences are not quickly forgotten. Many of the other current economic problems are a result of the stubbornness of these inflationary expectations.

With moderate monetary expansion, the basic economic forces pushing the economy to potential equilibrium would probably be interfered with least, and experience indicates that progress toward reducing inflation and unemployment would be enhanced in 1972. Neither full employment nor price stability is likely during the coming year, but a basis would be established to reach these goals more quickly in the following years.

### Conclusions

Inflation, which began in the mid-1960's, has been a serious problem in 1971. By the amount of attention devoted to the problem and the actions taken, it can probably be concluded that the public has underestimated the costs resulting from inflation and the problems of eliminating it.

The transition to a slower rate of price increase has involved costs. Total real product changed little from mid-1969 to the end of 1970, and has remained below capacity levels in 1971. Yet, given the strongly imbedded inflation, the costs of reducing it have been

moderate as compared with previous attempts at arresting inflation. The milder approach, with its continuing costs spread over a longer period, however, has increased public anxiety.

To hasten progress toward full employment and price stability, the country has adopted the New Economic Program, with direct controls over wages and prices. This approach may help speed up the downward adjustment of price expectations, but experience indicates that it involves risks. It is essential that care be taken to avoid those monetary and fiscal actions that are likely to reinforce the inflationary pressures.

More rapid solution to the problems of inflation and underutilization of resources could be accomplished by improving the market system. Such actions might include reducing subsidies, tariffs and import quotas, widening the range of anti-trust laws to cover more monopolistic practices, eliminating outdated building restrictions and other barriers to greater productivity, improving skills of workers and information on job openings, and modifying the minimum wage laws in the interest of improving job opportunities for the inexperienced and handicapped.

Progress has been made on the inflation problem. Transitional costs incurred in reducing inflation are also receding. As long as total spending continues to grow at a moderate rate, both the inflation and the capacity utilization problems will gradually be solved as the effects of past maladjustments recede.

