1973 – A Year of Inflation

by NORMAN N. BOWSHER

A MAJOR setback in the struggle against inflation was suffered during 1973. Average prices, as measured by the GNP price deflator, rose at a 6.8 percent annual rate over the first three quarters of the year. From 1965 to 1972 prices rose at an average 4 percent rate. Fiscal developments became less expansive in 1973, interest rates rose markedly, and the growth rate of the monetary base slowed slightly. Nevertheless, price stability remains an elusive goal in view of the strongly imbedded expectations of continuing inflation.

At the beginning of 1973, many observers felt that the pace of inflation might accelerate from the 3.2 percent annual rate experienced from early 1971 to late 1972, but few, if any, were able to forecast the severity of the 1973 inflation. The President's Council of Economic Advisers was quite optimistic, actually anticipating a moderate decline in the rate of price increases in the course of 1973.[1] More typical of price expectations as the year began was the sentiment expressed in the last sentence of an article which appeared in this *Review* last December: ". . . as 1973 begins, it appears to most forecasters that inflationary pressures may mount during the year."[2]

The explosion in prices that actually occurred during 1973 was startling, even to those anticipating an acceleration in price markups. In fact, many of the strong influences on prices during the year could have been only partially anticipated as the year began. Examples include: the price effects of reduced output of some feed and food crops abroad; the devaluation of the dollar in February and the subsequent additional slide in the dollar's value in international markets; the inflations in Europe and Japan; price controls which made it expedient to reduce livestock production and shut down food processing plants while demand for food was rising; and the energy crisis.

A listing of such special influences on individual prices gives an exaggerated impression of the effect of these irregular developments on the trend of average prices. Without denying the substantial impact of unusual demand and supply factors on individual prices, it appears that the previous trend of economic activity and stabilization actions taken earlier have nonetheless been the major influences on price developments in 1973. In this review of 1973, discussion is first devoted to these earlier developments. Then, after examining economic developments of 1973, an outlook for 1974 is presented.

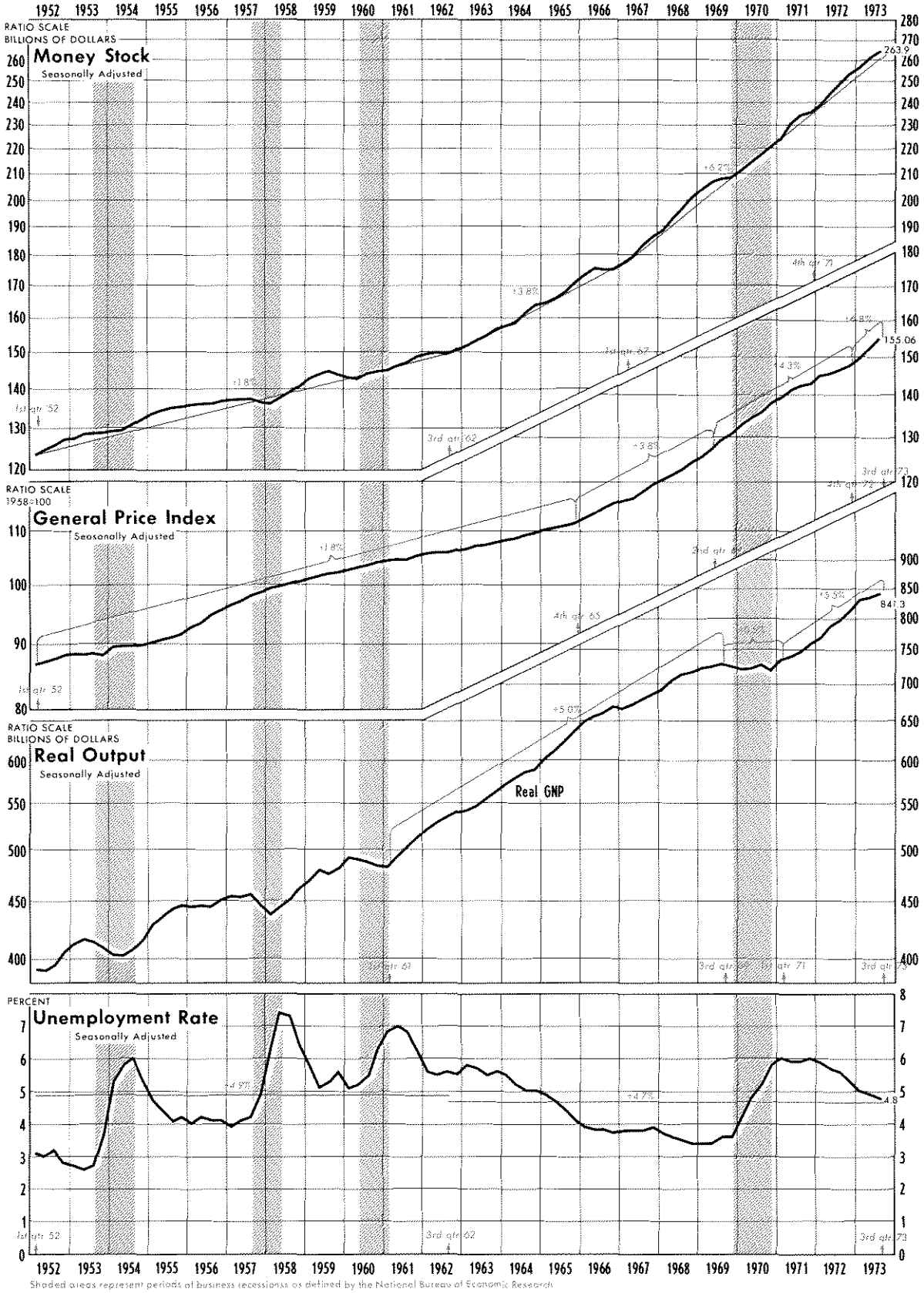
Framework of Analysis

The approach used in this discussion follows a prominent view which holds that changes in the growth rate of money have important effects on spending, prices, production, and employment. According to this view the trend growth of money over

[1] *Economic Report of the President,* January 1973, page 82.

[2] Norman N. Bowsher, "1972 – A Year of Rapid Economic Expansion," this *Review* (December 1972), p. 10.

Influence of Money on Prices, Output and Unemployment



Shaded areas represent periods of business recessions as defined by the National Bureau of Economic Research
Latest data plotted: 3rd Quarter

extended periods, say four years or longer, has a dominant effect on the trend of prices. Marked changes in the growth rate of money around this trend, lasting about three quarters or more, have effects on production and employment; but once a trend growth of money is fully reflected in prices, the production and employment effects vanish.

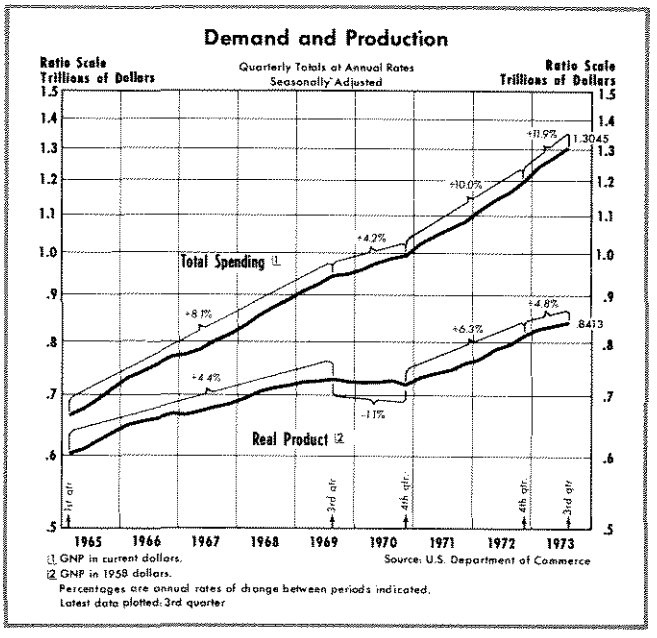
This monetary approach does not neglect the role of Federal budget developments, however. Changes in Government spending, in particular, have transitory effects on total spending in the economy for several quarters. These effects tend to be positive initially, and then are reversed as a crowding-out effect of the financing of Government expenditures results in reduction in private outlays.[3] In addition, Government taxing and spending actions can alter the allocation of income, affect long-term economic growth rates, and influence monetary growth rates.

Background

The last economic recession in this country extended from late 1969 to late 1970. From the third quarter of 1969 to the end of 1970, real output declined moderately and the unemployment rate rose. However, the recession was mild, especially when adjusted for the adverse effects of a large auto strike late in 1970. Total spending on goods and services continued to rise throughout this period at a 4 percent annual rate, or at approximately the same pace as the long-run expansion of productive capacity. The acceleration of inflation was halted, and progress was made toward price stability. During 1971, forces generating recovery appeared to be dominant. Nevertheless, it was felt by policymakers that the economy should be strongly stimulated in an effort to obtain more production and a higher level of employment within a relatively brief period.

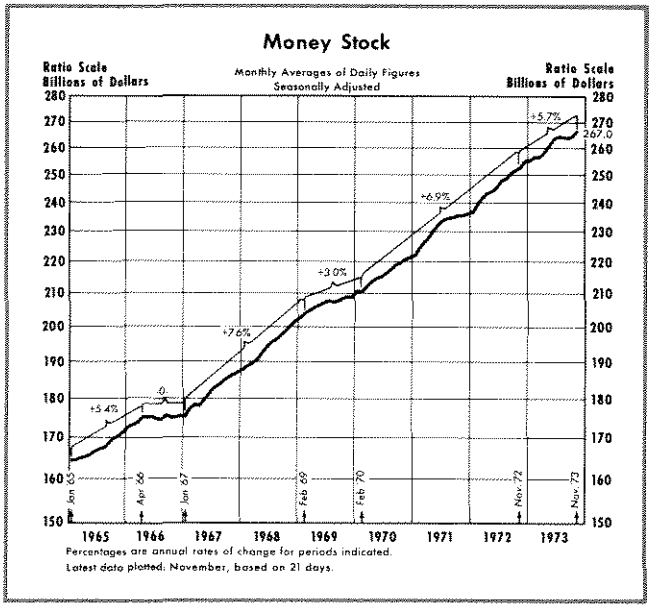
During and following the 1970 recession, fiscal actions were more expansive in an effort to stimulate economic activity. Taxes were reduced through tax reform, cuts in excise tax rates, increases in personal tax exemptions, and restoration of an investment tax credit. Government expenditures rose at an 11 percent annual rate from early 1970 to late 1972. The high-employment budget of the Government (which attempts to abstract from the influence of actual economic activity on the realized surplus or deficit) moved from a $12 billion surplus in calendar year 1969 to a $3 billion deficit in 1972.

[3]Roger W. Spencer and William P. Yohe, "The 'Crowding Out' of Private Expenditures by Fiscal Policy Actions", this *Review* (October 1970).



Monetary developments also became much more stimulative in the 1970-72 period. Growth in the money stock, which had averaged 3 percent from early 1969 to early 1970, accelerated to an average 7 percent rate from early 1970 to the end of 1972. By comparison, the trend growth of money from 1957 to 1965, when prices were relatively stable, was at an average 2.5 percent rate, and in the inflationary period of 1965 to 1968 money rose at an average 5.2 percent pace.

Reflecting the more expansive monetary and fiscal actions, total spending on goods and services accelerated markedly after 1970. Gross national product,



which rose at a 4.2 percent annual rate from the fall of 1969 to the end of 1970, climbed 9.3 percent in 1971 and 10.6 percent in 1972. During this period the rate of inflation continued to slow as a result of the delayed effects of the monetary and fiscal discipline in 1969, in addition to the initial impact of the controls on wages and prices which began with the freeze in August 1971. Prices, as measured by the GNP deflator, slowed to a 3.2 percent pace from early 1971 to late 1972 from a 6 percent pace in late 1969-early 1970.

With spending rising rapidly and the rate of inflation moderating, production, employment, and real income expanded markedly. From the last quarter of 1970 to the last quarter of 1972, total real output, for example, rose at a rapid 6.3 percent annual rate, after having declined slightly, on balance, in the previous five quarters.

Resource utilization became more intense with production rising at a much faster pace than capacity. Although some plants and workers remained unemployed, producers began finding it more difficult to obtain the resources desired for further rapid expansion. In the final months of 1972, indications of a renewal of expansionary forces were becoming evident. Despite Phase II wage and price controls, consumer prices rose at a 4.2 percent annual rate from June 1972 to January 1973, up from a 3 percent rate of increase in the first half of 1972.

Economic Activity in 1973

As the year began, the upward momentum of spending, production, and employment was strong. Stabilization actions of the Government, which usually operate with some lag, had been unusually expansive throughout 1972. The volume of unused resources was not large and was being reduced steadily. In short, strong demands for goods and services were beginning to press against limited supplies, a situation conducive to an inflationary surge.

Economic activity continued to expand at a very brisk pace during much of 1973. Total spending rose at an even faster pace in the first three quarters than it did in 1971 or 1972. Production and employment, although strongly stimulated by a vigorous demand, increased at less rapid rates as the year progressed reflecting, in part, capacity constraints. Prices, as a result, rose sharply, and for some items, where the upward trend of prices was delayed by Government controls, shortages developed.

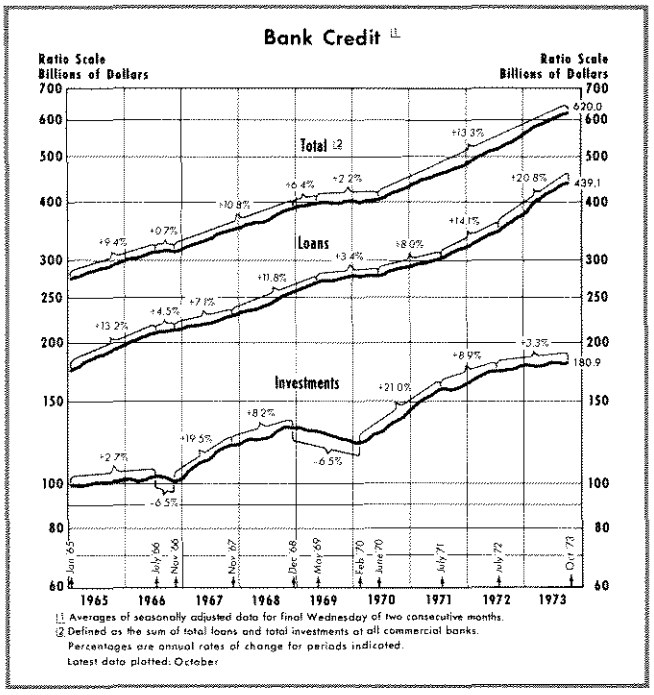
Spending – Total spending on goods and services expanded at an 11.9 percent compounded annual rate in the first three quarters of 1973. In 1972, total spending rose 10.6 percent, and in 1971 it increased 9.3 percent. By comparison, the trend growth of spending (1957 to 1971) before the recent surge was at a 6.4 percent pace.

Market forces allocated the marked gains in aggregate spending across nearly every sector of the economy. The distribution of spending was also influenced to a degree by nonmarket constraints such as interest rate ceilings, other price controls, and subsidies.

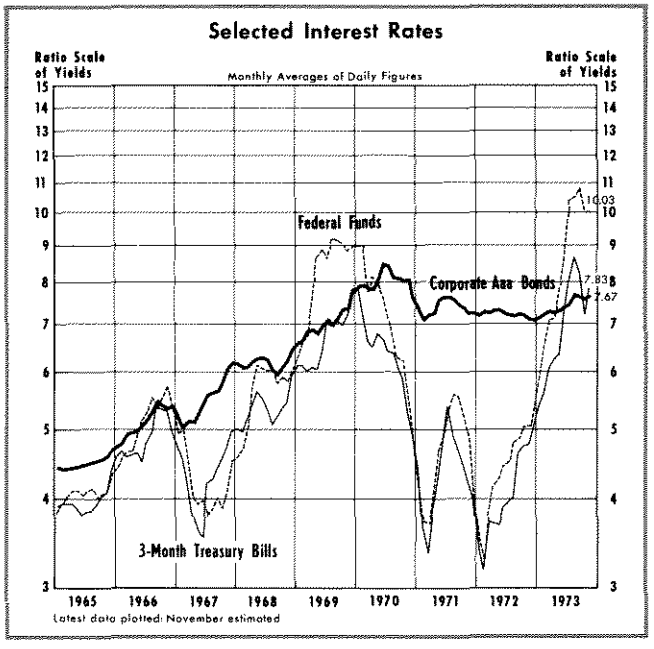
Consumers increased their outlays substantially during 1973. For a brief period during the summer the hectic pace of buying meat and home freezers verged on a scare-buying panic. Expenditures on automobiles and other durable goods rose at an 11 percent rate in the first three quarters of 1973, and spending on nondurable goods and services expanded at a 12 percent pace. Business investment increased at a 9 percent rate, and Government purchases of goods and services rose at a 10 percent annual rate. The nation had net exports of goods and services to foreigners in the first three quarters of 1973, following net imports in the previous year. This change in our net foreign position reflected both a more realistic pricing of the dollar in foreign exchange markets and a sharp increase in worldwide demand for U.S. farm and food products.

Some slowing in the rate of spending growth developed in the late summer and fall of this year. In the first seven months of 1973, for example, total retail sales rose at a 15 percent annual rate. From July to October, these sales increased at only a 5.5 percent rate.

Credit – Growth in spending, as is usually the case, was accompanied by a rise in credit outstanding. Total commercial bank credit expanded at a 15 percent annual rate in the first ten months of 1973. By comparison, commercial bank credit rose at a trend rate of 7.9 percent from 1957 to 1972. Mortgage credit extended by savings and loan associations increased at a 16 percent rate in the first eight months of 1973, while loans and securities of mutual savings banks grew at an 8 percent pace. Business advances, real estate loans, consumer credit, and Government indebtedness (including agencies) all expanded substantially. After mid-year, however, growth in real estate loans slowed as competition for a limited supply of funds intensified.



Reflecting the sharply expanded demand for credit pressing against a limited supply of funds from saving and from bank credit creation, the cost of credit, particularly for short-term funds, rose markedly in the first eight or nine months of 1973. In addition, there were fewer institutional obstacles distorting normal credit flows than there were in the 1969-1970 episode. For example, ceiling rates on large CDs were lifted, the rates that thrift institutions could pay to attract savings were raised, and some state usury laws were relaxed. While interest rates may have been bid

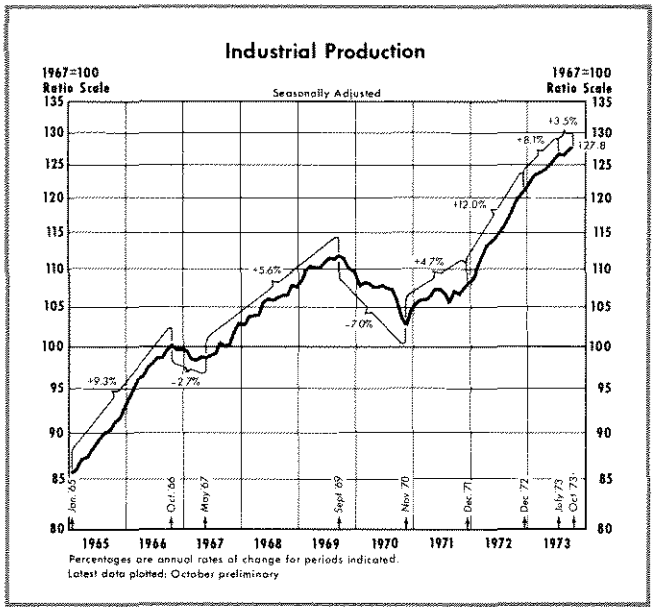


higher than they would have otherwise, the severe wrenching of a "credit crunch" was avoided.[4]

Yields on three-month Treasury bills moved up from about 5 percent in December 1972 to an average 8.67 percent in August 1973. The previous monthly peak in bill rates was 7.87 percent in January 1970. The announced rate on bank loans to prime business customers jumped (in a series of steps) from 6 percent in December 1972 to a level of 10 percent in late September and early October 1973, surpassing the previous all-time high of 8.5 percent in late 1969-early 1970. Interest rates on mortgages and long-term bonds also rose in this period, but since credit demands were largely focused on short-term obligations, the increase was much less dramatic.

Production — In contrast to the acceleration in the rise in spending, the rate of production growth slowed during the first ten months of 1973. Industrial production, which rose 12 percent in 1972, increased at an 8 percent annual rate in the first seven months of 1973 and at a 3.5 percent rate since July. A major factor in the slowdown was economic capacity limitations, which were adversely affected by a diminished outlook for profits resulting from price controls and environmental laws.

Total new construction, which rose 14 percent in 1972, increased at a 9 percent rate in the first four months of 1973, and has changed little since April.

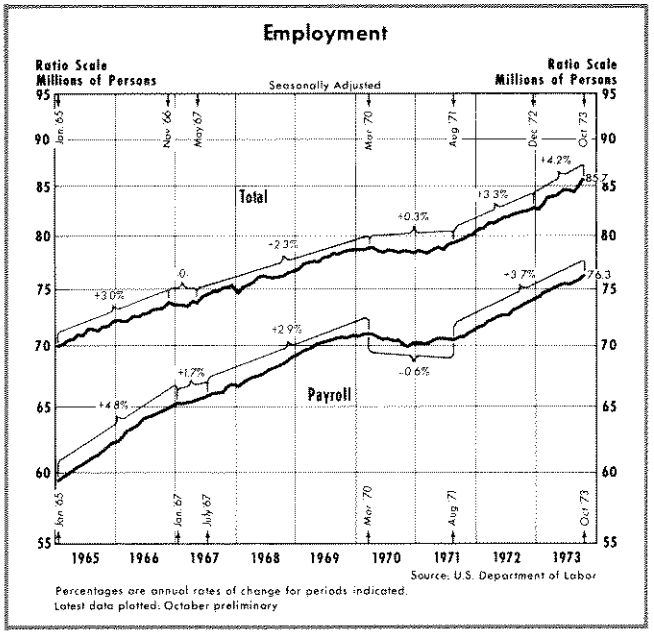


[4]The term "credit crunch" is used to refer to a period of financial stress wherein rapidly changing supply and demand forces, in combination with nonmarket interest rate regulations, sharply alter the flow of credit away from normal channels.

The trend since April reflects moderate declines in residential and Government outlays largely offset by expansion in commercial and "other" construction.

The growth rate in the real output of all goods and services (GNP in constant prices) also moderated during the year. After expanding 7 percent during 1972, it rose at a 5.5 percent annual rate in the first half of 1973 and at a 3.4 percent rate in the third quarter. However, the average 4.8 percent rate of growth during 1973 has been greater than the estimated long-run growth in productive capacity and hence more rapid than can be sustained over an extended period, given current growth rates in labor, capital, and technology.

Employment – Job opportunities were plentiful during the year. Total civilian employment expanded at a rapid 4.2 percent annual rate in the first ten months of 1973. This compares with the 1.6 percent trend growth in employment from 1957 to 1972. Even with the rapid rise in employment, some firms reported having difficulties obtaining employees at current wage rates, and as a result production growth was hampered at a time when demand for goods and services was expanding rapidly.



The unemployment rate among all civilian workers, which averaged 5.9 percent in 1971 and 5.6 percent in 1972, fell to an average of 4.9 percent in the first ten months of 1973. Among heads of households, unemployment was 3.7 percent in 1971, 3.3 percent in 1972, and 2.9 in the first ten months of 1973. Of those unemployed in 1973, over half had been seeking employment for less than a month.

As is frequently the case in periods of economic ebullience, efficiency of labor improved only slightly in 1973. In the first three quarters of the year, output per man-hour increased at a 1.5 percent annual rate. By sharp contrast, in 1971 the gain was 4.7 percent, and in 1972 it was 5 percent.

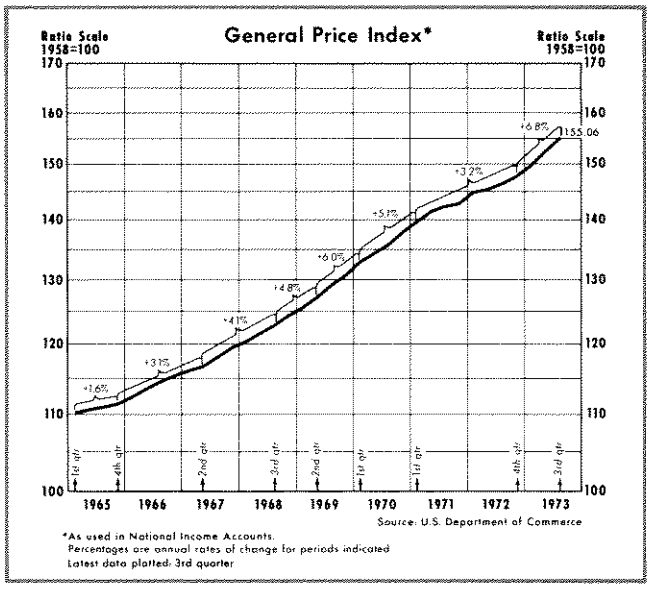
The reduced growth in labor output per hour was an important factor in the 6.7 percent increase in unit labor costs in 1973; this was up from a 2.3 percent rate in the two previous years. Another factor contributing to the jump in unit labor costs was that wages and other compensation rose at an 8.3 percent rate in the first three quarters of 1973, compared with increases averaging 7.3 percent in the two preceding years.

Income – Together with greater sales, production, and employment, incomes have been rising at a relatively rapid rate; however, most of the gains have been eroded by sharp increases in consumer prices. Total personal income rose at a 10.3 percent annual rate in the first ten months of 1973. By comparison, such income rose 10.2 percent in 1972 and 7.9 percent in 1971. After adjustment for changes in consumer prices, real personal income grew at a 1.3 percent pace in 1973 as against an average 5.5 percent pace in the two previous years.

Corporate profits recovered sharply during the year, but remained low relative to the mid-1960s when the inflation was first developing. In the first three quarters of 1973 corporate profits after taxes rose at a 26 percent annual rate, even though they turned down slightly in the third quarter. In the third quarter, profits were 5.5 percent of gross national product compared with 6.5 percent in the 1964-66 period. On the other hand, compensation of employees was 61 percent of GNP in the third quarter compared with 58 percent in 1964-66.

Prices – Most analysts agree that inflation has been a serious, if not the most serious, economic problem of the nation.[5] The inflation, which began back in the mid-1960s, was stronger in 1973 than in any of the previous years. Average prices, as measured by the GNP deflator, rose at a 6.8 percent annual rate in the first three quarters of 1973. This surpasses the previous peak of 6 percent, registered in the late 1969-early 1970 period.

[5]At its annual meeting in September 1973, the National Association of Business Economists were polled on what they considered the primary economic problem for the coming year, and 63 percent listed inflation. Government controls, the second most serious problem, received 14 percent of the vote.

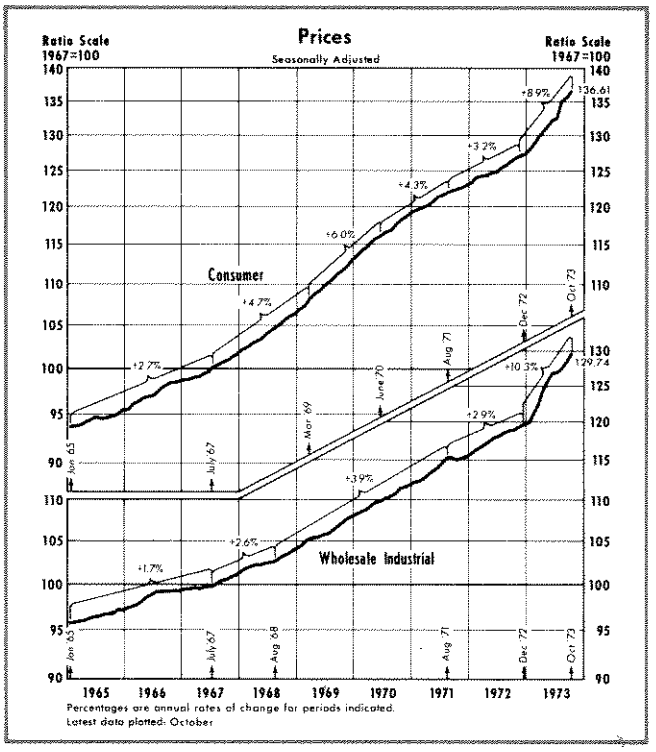


The inflation surge in 1973 occurred despite a Phase III system of price controls, a price freeze in the summer, and a Phase IV controls program which, in general, permitted only a "pass-through" of the dollar amount of higher costs. The sharp rise in prices reflected a number of factors. The chief upward force on prices resulted from a strong demand for goods and services, which was nurtured by the expansive monetary and fiscal developments of 1971 and 1972.

Some individual prices responded to cost-push forces generated by previous excesses. This was particularly true after both the expiration of Phase II controls in January and the devaluation of the dollar in early 1973. Then, too, there were bad weather conditions during the harvest period last year, a vigorous foreign demand for food, lumber, and other commodities, and an energy shortage at current prices.

Consumer prices rose at an 8.9 percent annual rate in the first ten months of 1973. By comparison, consumer prices rose at a 4.1 percent rate from 1965 to 1972, and at a 1.4 percent rate from 1953 to 1965. Since the rise this year was greater than the amount permitted to be paid employees under the controls programs, most individuals relying on wages and salaries as their primary source of income found that they had less real buying power at the end of the year than at the beginning. Similarly, most people owning savings accounts and bonds had the privilege of paying income taxes on interest "earnings" which didn't even maintain the purchasing power of the principal.

Wholesale prices rose even more sharply than consumer prices in 1973. In the first ten months of the



year, wholesale quotations were up at a 17 percent annual rate, compared with a 3 percent trend rate from 1965 to 1972, and an 0.8 percent pace from 1953 to 1965. Prices of industrial commodities rose at a 10 percent rate, and those of farm products and processed foods and feeds jumped at a 33 percent rate, on balance, in the first ten months of 1973.

Controls held back increases in the prices of some items for a time as evidenced by a number of shortages and interruptions to production as businessmen found it undesirable to produce at a loss or at the mandated profit margins. Over time prices have tended to move toward their equilibrium levels, and so the net effect of controls in the longer run seems to be less clear. Any contribution of controls toward lower prices, however, should be viewed in light of losses in output, the freedom of choice sacrificed, reduced incentives, quality deterioration, distorted resource allocation, and administrative costs.

Fiscal Developments

Fiscal actions taken before the start of the year had a major influence on economic activity during 1973. Actions taken in 1973 probably played a role also, particularly on economic developments late in the year.

Taxing and expenditure actions by the Federal Government in 1971 and 1972 probably had a tem-

porary direct expansionary effect on the economy, and may have had some indirect effect by influencing a faster pace of monetary expansion. Early in 1973 fiscal actions had a moderately stimulative impact, but later in the year actions became less expansionary.

Growth in Federal expenditures has been at a rapid 9.2 percent average annual rate since early 1970, according to the national income accounts budget. By comparison, from early 1967 to early 1970, Government expenditures rose at a more moderate 7 percent annual rate, despite large military spending for Vietnam. National defense outlays have declined since early 1970, reflecting the withdrawal from Vietnam and a changing of national priorities. On the other hand, social programs and other nondefense spending have been expanded at a rapid 15.1 percent average annual rate since early 1970.

Efforts to restrain the Government's spending growth had some effect during 1973, but the public's desire for more and more Government spending was difficult to resist. Since the last half of 1972, growth of total Government spending has been at a 7.8 percent annual rate, down from a 9.6 percent rate in the two previous years.

Government tax receipts have risen rapidly in recent years with the expansion in individual and corporate incomes, but the rise has been slowed somewhat by reductions in tax rates. Most significant were the Tax Reform Act of 1969, which had some effects in lowering tax receipts in later years, and the Revenue Act of 1971. In the latter instance, personal tax exemptions were increased, excise taxes on automobiles were eliminated, and a tax credit on investment was reinstated.

Not only did fiscal developments become more stimulative from 1970 through 1972, but the timing of some of the fiscal stimulus may have been shifted from 1972 to 1973 by an overwithholding of 1972 tax payments, which were refunded during 1973. This overwithholding, estimated to amount to about $9 billion, acted to restrain economic activity in 1972 but to stimulate it during 1973, particularly in the first half of the year. The overwithholding resulted from a change in the income-tax withholding tables incorporated in the tax law effective January 1, 1972. The change was designed to correct a previous underwithholding for certain taxpayers.

The high-employment budget, a widely used summary measure of fiscal impact, became progressively more expansive from 1969 through 1972. In calendar 1969, the budget was $11.8 billion in surplus. Reflecting larger increases in expenditures than in receipts, the surplus declined to $8 billion in 1970 and to $2.2 billion in 1971. In 1972, the budget turned into deficit by $3.1 billion. In the first quarter of 1973, the deficit was at an annual rate of $2.8 billion, but in the second and third quarters surpluses were again recorded, estimated at an average $5 billion rate.

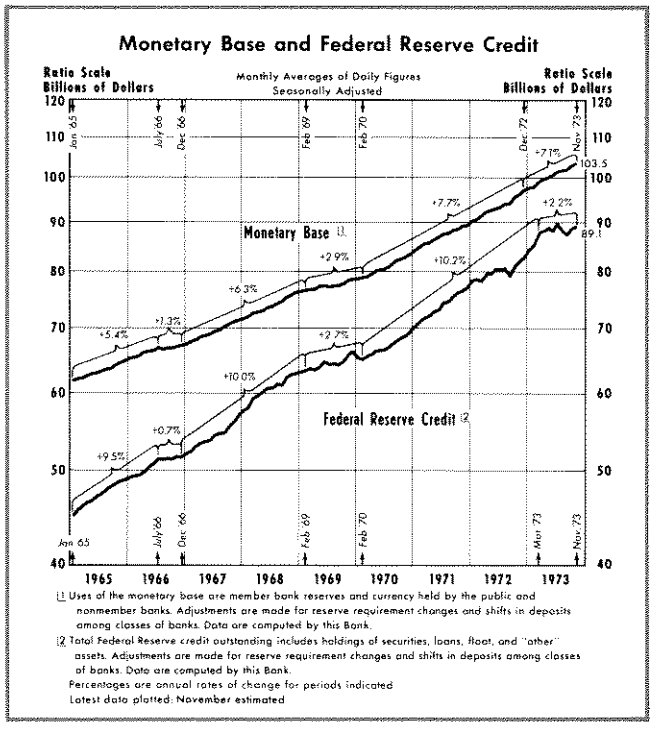
Monetary Developments

As stated above, monetary developments became progressively more expansive, on a year-to-year basis, from 1969 through 1972. Indications are that in 1973 monetary growth has been only slightly less than in 1972. During 1969 (from fourth quarter 1968 to fourth quarter 1969) the money stock of the nation – demand deposits and currency – increased 4.2 percent. In 1970 money increased 5.7 percent, in 1971 it went up 6.9 percent, and in 1972 it rose 7.4 percent. Published data show that from the fourth quarter of 1972 until the three months ending November 1973, money expanded at a 5 percent annual rate.[6] However, data available on nonmember bank deposits indicate that when the next benchmark revision is made, the data will show that money grew at a faster rate during the year.

Published data show that money plus net time deposits in commercial banks, a broader measure that some analysts find useful, rose at a 7.8 percent annual rate in the first eleven months of 1973. In 1972, this aggregate grew 10.6 percent and in 1971 it went up 11.5 percent. As with the data for the narrowly-defined money stock, forthcoming revisions are likely to raise, on balance, the 1973 growth rate of this aggregate. Total loans and investments of commercial banks rose at a 14.6 percent annual rate in the eleven months of 1973, after increasing 14.7 percent in 1972 and 11.5 percent in 1971.

The monetary base, the sources of which include Federal Reserve credit and the monetary gold stock, among other items, increased at an average 7.7 percent rate from early 1970 to the end of 1972 and at a 7.1 percent rate in the first eleven months of 1973. Growth of money fluctuated more than the base in 1973 because other uses of base (that is, time deposits and Treasury deposits) and the mix of money between demand deposits and currency, operated to

[6]November 1973 figures for money and money plus net time deposits are based on available data for the first 21 days of that month.



cause short-run fluctuations in the money stock. Over longer periods, the multiplier relationship between the base and money has usually been relatively stable.

Outlook

The upward momentum of spending, production, and incomes remains strong as 1973 comes to an end. However, signs of slowing have begun to appear in recent months. For example, growth in retail sales has moderated, credit demands have lessened, and short-term interest rates have moved down from their peaks. The composite index of twelve leading indicators of business activity, which rose at a 14.4 percent annual rate in the first half of 1973, increased at a 1.5 percent rate from June to September. Both monetary and fiscal actions have been slightly less expansionary, and the influence of these developments are usually observed only after some delay.

The "standard" forecast for 1974 is for continued increases in spending, production, and incomes, but at reduced rates from those in 1973. Some "cooling" in the economy from the pace which was causing intensified inflation is desirable. Barring major cutbacks resulting from the "energy crisis," and assuming that the Federal budget continues to be at near balance and that money growth is at a moderate rate, the economic slowdown should not turn into a recession.

A mild economic adjustment, however, means that progress in reducing the rate of inflation is likely to be slow. Many people are basing their actions on the belief that prices will continue to rise, and in addition, many contracts are based on an expected inflation. Then, too, because of controls, information costs, inertia, and other forces causing lags in establishing prices, a number of prices are currently below anticipated long-run equilibrium levels. As some prices move up, the natural forces of the market exert upward pressure on other prices. Most forecasts of price behavior for 1974 are in the 4 to 6 percent range of increase. Policies designed to bring less inflation within a one-year span would likely be accompanied by a downturn in output and employment.

Conclusions

The current inflation began in the mid-1960s in response to increased expenditures for the Vietnam war, a rapid acceleration in the implementation of social programs, and the methods by which these activities were financed. The inflation has been costly, and, to the distress of many, it has been stronger in 1973 than in any other year since it began.

Given the strongly imbedded inflation, it serves no purpose to pretend that there is a quick, easy, or costless cure to the economic disarray. Inflationary expectations were built up gradually over a number of years, as time after time those who failed to anticipate the inflation in their economic decisions sustained losses. These experiences probably will not be quickly forgotten.

On two occasions, in 1966-67 and in 1969-70, vigorous efforts were made to attack the basic causes of inflation by monetary and fiscal restraint. There were costs in terms of foregone production and employment. In each period, the tempo of economic activity slowed in response to the initial withdrawal of monetary and fiscal stimulus. Substantial progress was made in combatting inflation, and after a brief period, the economy resumed expansion at the estimated maximum sustainable rate. However, in both recovery periods stabilization emphasis shifted to the goal of obtaining a faster expansion, and the benefits of the previous periods of policy moderation were lost. After about two years the rate of inflation in each case became even more intense than it was prior to the adoption of restrictive policies.

Beginning in August of 1971, another approach to restraining inflation was attempted. Advocates believed that by implementing direct controls on prices, less inflation without the adverse effects of lost pro-

duction could be attained. The program appeared to have some initial success under the freeze, but experience both in this country and in others indicates that controls are not likely to hold back prices for long. Controls do not remove the basic economic forces which cause inflation, but are only an attempt to restrain the symptoms.

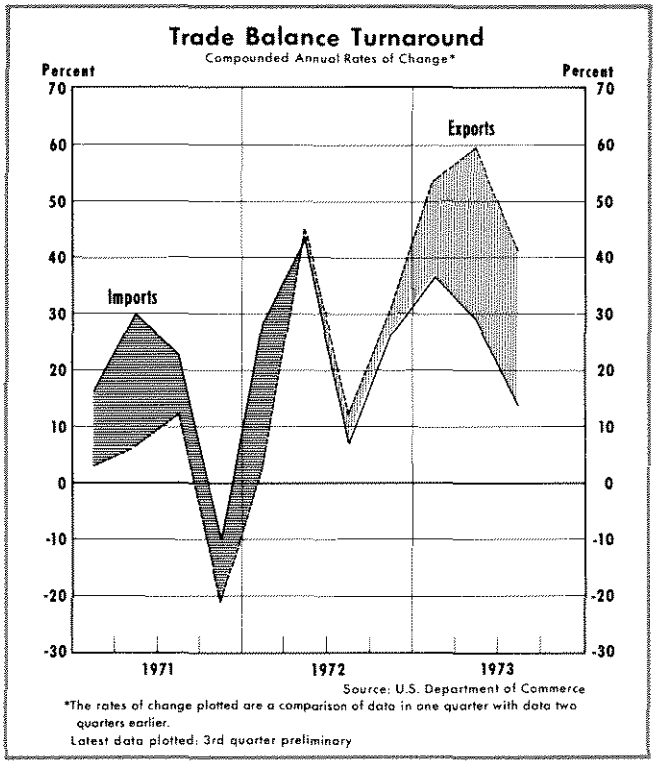
During 1973, a third effort at resisting the basic causes of inflation has been initiated. Monetary and fiscal actions have become somewhat less expansive. Success in substantially reducing inflation may involve greater costs now, in terms of lost production, than would have been required in the 1966-67 and 1969-70 periods, since the current inflation is stronger and more firmly imbedded. If withdrawal of stimulus is slow, production should continue to grow, but at a slower pace for perhaps a year before returning to a long-run maximum sustainable pace. Under these conditions, inflation should gradually dissipate over a period of about four or five years, assuming that policies are not changed again to achieve a more rapid, but unsustainable, expansion. Developments in 1974 will be crucial in determining whether this effort to resist inflation will be successful.

U.S. BALANCE-OF-PAYMENTS DEVELOPMENTS DURING 1973*

The U.S. international economic situation in 1973 was dominated by movement toward surplus in the trade balance.[1] Other major events which transpired during the year were the following: massive short-term capital outflows in January and February, dollar devaluation on February 12, the subsequent floating of major currencies against the dollar followed by continued dollar depreciation until early July, and then a strengthening in the international price of the dollar. Since the physical quantities of both exports and imports respond only slowly to exchange rate alterations, the U.S. trade balance was probably only marginally affected by the 1973 dollar depreciation. However, the currency price changes may exert a stronger influence on this balance in 1974.

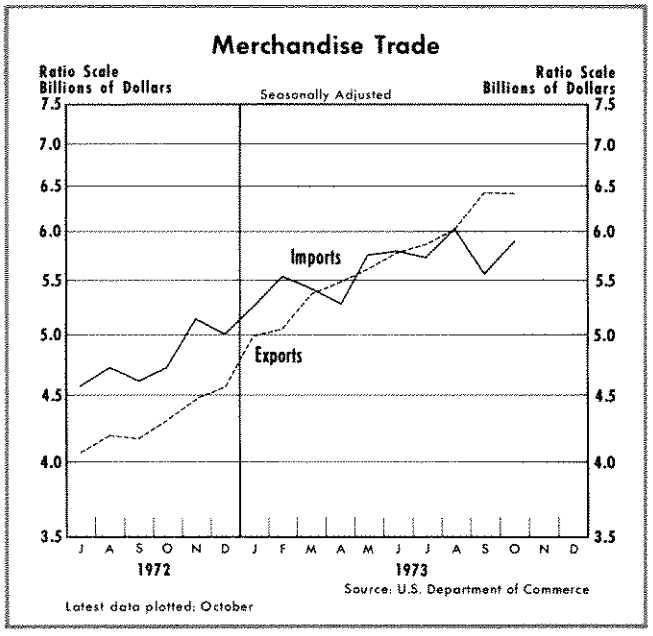
Trade Balance

The devaluation of the dollar in December 1971 apparently started to influence the quantities of exports and imports in mid-1972 when it became apparent that the rate of increase of U.S. purchases of imports declined, and the rate of increase of foreign purchases of U.S. exports increased. This reversal of trends is illustrated in the accompanying chart. During 1973 the reversal in the rates of increase in U.S. exports and imports became more pronounced as a number of factors reinforced the effects of the initial



*This section was written by Hans H. Helbling.

[1]For an interpretation of balance-of-payments terminology, see John Pippinger, "Balance of Payments Deficits: Measurement and Interpretation", this *Review* (November 1973).



dollar devaluation. Such additional factors include: differences in the rates of inflation here and abroad, international differences in business activity, strong demand for raw materials, and special factors such as poor harvests abroad.

On balance, from January to October 1973 the trade balance was in surplus by $0.8 billion at an annual rate. This compares to annual deficits of $2.7 billion in 1971 and $6.9 billion in 1972.

During the first ten months of 1973 the recorded value of U.S. exports increased by 42 percent, while the recorded value of U.S. imports increased by only 24 percent.[2] In fact, exports were absolutely greater than imports in April, July, September, and October. Although the April and July surpluses were between $100 million and $200 million, the September surplus was a substantial $873 million, and the October surplus amounted to $527 million.

During 1973 the rates of increase of agricultural commodity exports and petroleum product imports significantly exceeded the rates of increase of total exports and imports. Exports of agricultural products increased at a rate of 86 percent during the first eight months of 1973, compared to a 39 percent rate of increase in total exports in the same period.[3] For comparison, agricultural exports increased by 22 percent in 1972 and by 7 percent in 1971.

[2]Percentage increases are measured in relation to the same period a year earlier, unless stated otherwise.

[3]Data for agricultural exports and petroleum imports were available only for the first eight months of 1973. Data for physical quantities of exports and imports were available only for the first half of 1973.

Petroleum imports reached a rate of increase of 58 percent for the first eight months of 1973, compared to total imports which grew by only 24 percent during this period. Petroleum imports grew persistently from a 29 percent rate of increase in 1972 and, apart from possible embargoes, could be expected to increase as domestic oil consumption continues to exceed domestic production.

The physical quantity of our exports was 21 percent greater during the first half of 1973 than in the second half of 1972. From the second half of 1971 to the first half of 1972, this rate of increase was 11 percent. The quantity of imports, on the other hand, was 7 percent greater during the first half of 1973 than in the second half of 1972. From the second half of 1971 to the first half of 1972 this rate of increase was 12 percent.

Basic Balance

The basic balance, which encompasses merchandise trade, services, unilateral transfers, and long-term capital flows, was in deficit by $3.5 billion during the first half of 1973.[4] This compares to a deficit of $9.8 billion for 1972. However, during the third quarter of 1973 this balance was probably in surplus by as much as $4 billion.[5] It follows, then, that the basic deficit for the first three quarters of 1973 would be about $1 billion. This reduction is largely caused by the movement of the U.S. trade balance into surplus, but also reflects increased receipts by U.S. corporations and individuals of investment income from abroad.[6] Despite increased foreign direct investment expenditures in the United States, there were somewhat larger outflows of net long-term capital from the United States during the first half of 1973, as compared to 1972. Moreover, foreign purchases of U.S. securities declined during the second quarter.

During the third quarter, however, foreign purchases of U.S. securities have increased again. If such purchases continue, and the trade balance continues in surplus, the U.S. basic balance should approach equilibrium or perhaps even move into surplus for the year as a whole.

[4]All balance-of-payments figures are reported as seasonally adjusted annual rates.

[5]This estimate is based on preliminary U.S. Department of Commerce data for the third quarter which indicates that net foreign purchases of U.S. securities amounted to $4.9 billion and bank reported long-term capital inflows amounted to $1.3 billion.

[6]The increased receipts from investment income is partly related to the dollar depreciation which has the effect of increasing the dollar value of a given amount of foreign-currency denominated earnings.

Net Liquidity and Official Settlements Balances

The net liquidity balance includes, in addition to the basic balance, private and official short-term capital flows and errors and omissions. This balance was in deficit by $26.6 billion in the first quarter and $6.4 billion in the second quarter. For the third quarter, however, a surplus of $4.2 billion developed, the first surplus since the fourth quarter of 1969. This compares to deficits of $22 billion and $13.9 billion for 1971 and 1972, respectively.

The official settlements balance registered a deficit of $42 billion for the first quarter, and surpluses of $1.5 billion and $8.6 billion for the second and third quarters, respectively.[7] This balance was also in continuous deficit since the fourth quarter of 1969, reaching $29.8 billion in 1971 and $10.3 billion in 1972.

The extreme deficits in these two balances in the first quarter reflect massive short-term capital outflows preceding the February dollar devaluation. The second quarter reduction in the net liquidity deficit and the surplus in the official settlements balance, as well as the third quarter surpluses in both balances, were probably related to the floating of major currencies against the dollar. This floating had the effect of equilibrating private supply and demand for dollars which, therefore, eliminated both the incentives for large-scale dollar outflows from the United States and the accrual of dollar balances on the part of foreign central banks. Moreover, the differential between U.S. interest rates and Eurodollar interest rates narrowed and led to an increase in borrowing on the part of U.S. banks from foreign banks.

These factors explain the net short-term dollar inflows during the second quarter amounting to $4.6 billion, and third quarter inflows which were probably also large. This compares to net outflows of short-term capital amounting to $38.6 billion during the first quarter. The rising dollar exchange rate and reductions of dollar holdings on the part of foreign central banks may be an indication that both the net liquidity and the official settlements balances will record surpluses in the fourth quarter of 1973.

[7]The difference between these two balance-of-payments concepts is the treatment of liquid private capital flows. These flows are included in the official settlements balance but not in the net liquidity balance. Thus during the first quarter of 1973 the net liquidity deficit was less than the official settlements balance by the amount of liquid private capital outflows. Because liquid private capital inflows exceeded the net liquidity deficit during the second quarter of 1973, an official settlements surplus resulted.

Dollar Exchange Rate

After the February 12 devaluation, the dollar continued to depreciate in foreign exchange markets. By July 6, the depreciation amounted to 21.2 percent on a trade-weighted basis, compared to 15.2 percent immediately after February 12.[8] However, in light of the improved price competitiveness of U.S. products in world markets, and the movement toward equilibrium in the basic international transactions of the United States, the continuing dollar depreciation was puzzling to both U.S. and foreign observers.

Following a meeting at the Bank for International Settlements (BIS) in early July, representatives of the major central banks decided to implement, if deemed appropriate, an earlier agreement regarding exchange market intervention to "maintain orderly markets." Furthermore, the U.S. Treasury approved the drawing on swap lines to finance U.S. exchange market intervention, and the Federal Reserve System announced an increase in the swap network from $11.7 billion to $18 billion.[9] Although intervention by both the U.S. and foreign central banks remained minimal in amount, the dollar price in terms of foreign currencies began to stabilize.

This halting of the dollar price decline apparently reflected official willingness to intervene in foreign exchange markets as well as recognition that equilibrium in the basic international transactions of the United States was imminent. Finally, on October 25 the international price of the dollar began to increase sharply. This probably reflected the large September trade surplus and the recognition that oil shortages would affect Europe and Japan more than the United States. By November 27 the trade-weighted depreciation of the dollar, at 15.3 percent, was virtually the same as immediately after the February dollar devaluation.

Summary

Considerably improved price competitiveness for U.S. products in world markets, aided by the reduction in the international price of the dollar, resulted in

[8]The trade-weighted dollar depreciation is measured by changes in the values of 11 major currencies relative to exchange rates prevailing in May 1971, weighted by trade shares with the United States.

[9]Swap lines are short-term reciprocal lines of credit between the Federal Reserve System and 14 major foreign central banks plus the Bank for International Settlements. The Federal Reserve System, in effect, can borrow foreign currency in order to purchase dollars in the foreign exchange market.

a small trade surplus so far this year. This trade surplus dominated movements in other components of the balance of payments and generated movement toward equilibrium in the basic balance.

The balance of payments during 1973, as measured by the net liquidity and the official settlements concept, was in deficit as large net short-term capital outflows occurred prior to the dollar devaluation of February 12.

There are two factors which augur for substantially smaller deficits in the net liquidity balance and perhaps surpluses in the official settlements balance in the future: 1) the currency realignment of February 1973 reduced the international price of the dollar substantially; 2) eventual equilibrium in the basic balance of payments and the absence of expectations of further capital gains in other currencies should promote confidence in the dollar as an international asset. Both factors should remove the incentives for dollar outflows from the United States and may be conducive for further reflows of dollars to the United States. However, these developments may be affected by increased costs of U.S. imports of oil.

Prospects for 1974 suggest a slowdown in economic activity in the United States. But, the very restrictive monetary policies of major foreign countries in recent months will also lead to economic slowdowns abroad. This may have the effect of reducing U.S. import demand as well as foreign demand for our exports. However, due to the increased price competitiveness of U.S. goods in world markets, a complete reversal of recently established export and import trends is not likely to materialize.