CHAPTER 2

Outlook and Policy

THE GOALS FOR THE PERFORMANCE OF THE ECONOMY IN 1971 ARE CLEAR. Our objectives should be to move along a path through 1971 that will bring the unemployment rate in 1972 down to the zone of reasonably full employment, and at the same time to get the rate of inflation down to the 3-percent range. The general nature of the policies that would help to achieve each of these goals is also clear. We can reduce unemployment, at least in the short run, by expansive economic policies which would make the demand for output rise rapidly and so raise employment. We can reduce the rate of inflation by restrictive economic policies which would repress the demand for output, increase unemployment and unutilized capacity, and thereby encourage business and labor to settle for smaller advances in prices and wages. While these "solutions" are clear, the problem is also clear. We cannot do as much as would be possible in one direction without injurious results in the other. This is not to say that it is impossible to make progress in both directions at the same time. It is possible, but only if we do not move too fast in either direction.

THE UNEMPLOYMENT-INFLATION DILEMMA

The dilemma of having to balance our efforts between reducing unemployment faster and reducing inflation faster is not new. This itself is worth recognizing, because if the problem were truly new, the thinking and experience of the past would be of little value. In fact the dilemma has been one of the central concerns of economics and of economic policy throughout this generation. The problem came to the fore as early as 1936 and 1937 when the economy, although still at a very low level, was recovering from the Depression and prices began to rise. President Roosevelt called public attention to what he believed to be the dangers of the price increases. There were many who thought that the ending of the recovery in the sharp recession of 1937–38 was due to the earlier price rise, which they attributed to concentrations of economic power. This belief was one of the motives for the establishment of the Temporary National Economic Committee (TNEC) to investigate the concentration of economic power.

The work of the TNEC led to no conclusions on this point, because its report did not come until the war had superseded earlier concerns. Nevertheless, the problem of reconciling full employment and price stability was prominent in wartime thinking about the postwar economy. This was one of the reasons why some were reluctant to accept what they interpreted as the overly ambitious commitment to full employment implicit in the original "Full Employment Bill," an attitude that led to a less ambitious commitment in the Employment Act as enacted in 1946.

Discussion of the possibility of full employment without inflation continued in the first 10 years after the war. This was a period in which contemporary experience was dominated by the effects of wars, controls, and their aftermath, and it was not generally considered that it could provide much light on the characteristics of a normal peacetime economy. The events of 1955–57 intensified the concern with the problem. We then had the first full employment achieved in normal conditions since 1929, and it was accompanied by a disturbing increase in the inflation rate. From the third quarter of 1954 to the third quarter of 1957, prices (as measured by the GNP deflator) rose at an annual rate of 3.1 percent, reaching a peak annual rate of 5.4 percent in one quarter. Six quarters after the recession began the inflation rate was still 2 percent, and this contributed to the idea of inflation as a permanent problem. This experience lay behind the statements contained in the *Economic Report of the President* during that period about the need for responsible restraint in raising prices and wages.

In the upswing that followed, however, most measures of the general price level stabilized, and this stability continued through 1965. From mid-1958 to the end of 1965 the rate of inflation averaged 1.5 percent per year, as measured by the GNP price deflator, and 1.3 percent by the consumer price index. At the time this moderate rate of inflation was considered as being, for all practical purposes, "reasonable price stability." The experience, however, did not resolve questions about the compatibility of full employment and price stability. Unemployment was high during all of this period, although declining from 7.1 percent in early 1961 to 5.0 percent by the end of 1964 and to 4.5 percent in mid-1965. Some thought that the prolonged period of little inflation would create an environment stable enough so that a gradual reduction of the unemployment rate to 4 percent could be achieved without speeding up the inflation. Evidence that the inflation rate was holding steady at a low level as unemployment fell towards 4.5 percent encouraged this hope. But in fact the GNP price deflator began to rise soon after unemployment fell below 4 percent at the end of 1965, and there had been evidence of the beginnings of a rise in wholesale prices before that. This rise in the inflation rate and its sequel left several important questions unanswered. Would the inflation rate have increased if the drop in the unemployment rate from 5 percent to 4 percent had occurred more gradually? Would the inflation rate have stabilized at the still moderate figures registered late in 1965 if demand had remained just sufficient to keep unemployment at 4 percent? Or was some higher rate of inflation the inevitable accompaniment of the 4-percent unemployment rate?

Demand kept rising rapidly, although not without some interruptions, after the end of 1965, reducing the unemployment rate below 4 percent and pushing the inflation rate still higher. While this was happening, that is, until about the middle of 1969, the dilemma of policy disappeared. Unemployment had been driven down to a level where symptoms of labor shortages and tight labor markets were widespread. In those circumstances the proper course of policy was clear. Restrictive policy which would restrain inflation would carry with it little, if any, cost in the form of undesirable effects on employment. For the time the appropriate direction of policy was unambiguous.

The dilemma reasserted itself in early 1970 when we again experienced high and, for a time, rising inflation rates along with rising unemployment rates. This was a natural transitional combination, in view of the rapid inflation we had been experiencing. Once the rise of total demand was restrained, the effects were first felt on the real side of the economy—on output, employment, and unemployment—with prices continuing to rise as a result of forces set in motion earlier.

THE GOALS OF POLICY

There are several reasons for believing that from this point forward a further reduction of the inflation rate will be consistent with reduction of the unemployment rate:

1. A reduction of the inflation rate has already begun. This is reflected in most broad measures of the price level.

2. There is a lag between the emergence of slack in the economy and its effect on the inflation rate so that the full effects on prices of the sluggish economy in 1970 have yet to be felt.

3. If, as expected, employment rises at a moderate rate during 1971, sufficient slack will still remain in the economy to exert downward pressure on the rate of inflation.

4. With output rising fast enough to cut into the unemployment rate, a high rate of productivity growth should continue through 1971. Stern cost-cutting measures in 1970 have put businesses in a position to achieve more favorable trends in costs per unit of output as operating rates improve. This will help to limit the pressures of these costs on prices.

To go beyond these general statements of direction and try to estimate how much unemployment and inflation could be reduced, we must move cautiously. However, some approximate judgments seem consistent with recent as well as earlier experience. Confining the economic expansion to a pace which would keep unemployment about where it now is, in the neighborhood of 5.5 to 6.0 percent, would permit a significant decline in the rate of inflation during 1971 and 1972. To allow so high an unemployment rate to persist for so long a time, however, would be inconsistent with the Employment Act—and undesirable even if there were no Act. On the other hand, trying to restore what has been commonly regarded as "full

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employment"—a 4-percent unemployment rate—within the present planning period that extends to the end of fiscal year 1972 would entail risks on the inflation side. Although this latter path might be consistent with some further reduction of the inflation rate, there is a serious risk that the inflation rate would start rising again if the 4-percent unemployment rate were approached as rapidly as such timing would imply.

There is a feasible path between these extremes that would better meet the Nation's present requirements by allowing significant progress to be made against both inflation and unemployment. This is a path that would see the unemployment rate reduced to the 4½-percent zone by the second quarter of 1972 and the inflation rate, as measured by the GNP deflator, declining to approach the 3-percent range at the same time. Total output would have to rise significantly faster than the growth of potential output, or employment would rise only in proportion to the growth of the labor force and would not cut into unemployment. The necessary rate of increase of total output, however, would not have to exceed the rates that have been achieved during past periods of economic recovery.

The general goal, which is more important than the precise numbers, is that the rate of unemployment should decline as fast as is consistent with a reasonably steady and durable decline in the rate of inflation. We believe that the numbers we have proposed—an unemployment rate in the 4½-percent zone and an inflation rate declining to approach the 3-percent range by mid-1972—are feasible representations of that goal. But the numbers are themselves not the fundamental goal.

It has to be recognized that achievement of this goal would still leave the economy short of the ideal with respect to both unemployment and inflation. As things turn out, the economy may yield better results on both sides than are projected here. But it would be unrealistic to count on such an outcome, and irresponsible to hold out to the American people the idea that there are readily available policies which would achieve it. The long and accelerating inflationary boom that was set off beginning in late 1965 left the country with this unemployment-inflation dilemma, whose severity was only subsequently appreciated. But to move firmly along the path laid out would relieve the anxiety about the economy from which the country has been suffering for many years and generate confidence in further progress.

IMPROVING THE UNEMPLOYMENT-INFLATION CHOICE

How rapidly we can move in expansion of the demand for output, with associated increases in production and employment, will depend heavily on the capability of the economy to resist the inflation of prices and costs. In many directions we see accumulating evidence of public weariness with a continuing deterioration in the purchasing power of its money. Surveys of public sentiment reveal it sharply. Widespread public support for direct price and wage controls clearly reveals public frustration with inflation even if the full consequences that these controls would have in distortions and black markets are not perceived. Developments which persistently force costs and prices upward will simply prolong unemployment and the sluggish spending inclination of consumers. And growing confidence in prospects for a reasonably stable price level would make a major contribution to invigorated consumer spending and improved economic conditions generally.

Broad fiscal and monetary policies must continue to play the basic role. How expansive these policies can be, however, will depend on what more can be done to enable the economy to translate rising demand into rising output, employment, and real incomes rather than into a more rapidly rising cost-price level. This list of other possible actions, beyond the prudent management of fiscal and monetary policies, is long and varied. The problem is to select those which would be, on balance, helpful. It is not solved by saying that reliance on fiscal and monetary restraint alone will make the process of disinflation slower and more painful than we would like. That is a restatement of the problem, not a solution to it.

As a basis for thinking about the problem, several points must be borne in mind:

1. The free market system of determining prices and wages, even with its imperfections, serves exceedingly well in shaping what gets produced and by whom, and how the resulting income gets distributed. These are key questions in any economy, and no effective substitute for this market economy has been found that answers them better. We take the free market system for granted, like the air we breathe, and become conscious of the benefits of either only after they have been lost.

2. There is now a great deal of experience to indicate that the superficially attractive route of voluntary controls is unlikely to lead to a solution. By "voluntary controls" is meant a system in which the Government, or a quasi-independent board selected by the Government, specifies comprehensive standards of wage-price policy to be observed voluntarily by labor and business, without any similarly comprehensive means of enforcement by Government. The basic deficiency in this approach is that it counts on a large number of people to acquiesce in conduct that they find contrary not only to their own interests but also to their view of fairness, propriety, and efficiency. The great initial attraction of the idea, that it makes the public think something effective is being done, is also one of its adverse consequences because it distracts attention from the real nature of the problem.

3. At the same time, it is evident that some price and wage increases that are going on are not adaptations to current basic market conditions and are not consistent with efficient operation of the economy. To some extent this simply reflects a lag in adjustment to the change in market conditions that has taken place in the past year. But in some cases the behavior

of prices or wages can be explained only by a combination of this factor with an unusual degree of insulation from competitive market forces.

4. In some cases the insulation from market forces is due to acts of commission or omission by the Federal Government. This may be true, for instance, in industries that are protected from foreign competition by import quotas or voluntary arrangements with similar effect. In these cases the Government has the instruments at hand for correcting the problem. This does not, in itself, make the correction easy. Those who have been the beneficiaries of a shelter from competitive forces would certainly feel aggrieved by changes in conditions on which they have come to rely.

Government policy must find its way among all these considerations. Short of an emergency of a kind which does not exist, mandatory comprehensive price and wage controls are undesirable, unnecessary, and probably unworkable. The Government should not rely upon pseudo-solutions for real problems and should not delude the public about doing so. But there are cases where price or wage increases not justified by competitive market forces are contributing to the prolongation of the inflation and to unemployment as well. In some of these cases the Government has means of correction available that do not interfere with market performance but tend rather to improve it.

What is called for is a policy of doing what can effectively be done, wherever it can be done, and not pretending to do more. The Administration set out on this course with the President's speech of June 17, 1970, and has since then been following it with increasing force.

In June the President directed the Council of Economic Advisers to issue a periodic *Inflation Alert* to call attention to specific cases or general features of exceptionally inflationary wage or price behavior. The purpose of these reports was to bring to bear on important wage and price decisions a more informed and sharply focused public attention. The Council will continue to issue the *Inflation Alert* approximately every 3 months. Certain points made in the December 1970 issue, prompted by developments in the immediately preceding period, are worth reiterating.

1. Apart from temporary aberrations the general price level tends to rise by the excess of wage increases over productivity increases. Productivity cannot be counted on for long to rise more than about 3 percent per year, although this rate will probably be exceeded during the next year. This means that a continuing 7-percent annual rate of increase of employee compensation per hour would commit the economy to a continuing inflation rate of about 4 percent.

2. We shall not make progress in reducing the inflation rates if the gains we hope to make on the labor cost front are offset by too rapid increases of profit margins.

3. If the inflation is to be slowed down, all wages that have not kept up with the inflation of prices cannot catch up in any short period. On the average, labor compensation has kept pace with the inflation and productivity

increases, but some wages have led and some have lagged. If those that have lagged were to catch up quickly, while the leaders did not fall back—as they surely would not in a short period—then the cost-price spiral is given another turn, prices rise further, and new laggards are created who feel they have to catch up.

4. To embody in wage agreements covering two or three future years provisions for wage increases based on the assumption that prices will continue to rise at recent peak rates is not a reasonable response to our present situation. If this were done generally it would be a recipe not only for permanent rapid inflation but also for persistent unemployment, because the Government would be bound to try to check the inflation by generally restrictive policies. On the other hand, in some cases escalator clauses, which relate future wage changes to actual variations in the cost of living rather than to the expectation of continued inflation at its peak rate, may have a role to play during the adjustment to a more stable price level.

The President's June 1970 speech also announced the establishment of the Regulations and Purchasing Review Board to correct Government policies which unnecessarily contribute to inflation. It has under consideration a number of problem areas on which recommendations will be forthcoming. Examples of these are the management of import restrictions, regulations which unduly increase the cost of bidding on small Government projects, design and procurement methods for Government buildings, and the administration of the Davis-Bacon Act, which requires that contractors on Federal construction projects pay "prevailing" wages (a provision which in practice may have exerted an inflationary effect on construction wage rates and costs).

It is the general policy of this Administration that where it has a legitimate role the Government should act to correct market conditions that prolong inflation, or whose correction can have a favorable effect on the price level. In line with this policy the Administration last fall took two steps to restrain increases of crude oil prices. It relaxed limitations on the importation of oil from Canada and permitted production of oil on Federal offshore leases without restriction by State regulatory commissions.

Following the announcement of a large increase in prices of some steel products in January 1971 the President directed the Cabinet Committee on Economic Policy to investigate economic conditions in the steel industry which were giving rise to such increases. To be taken into account in this review is the voluntary agreement by producers of steel in Japan and the European Economic Community to limit their sales of steel in the United States, an agreement negotiated by the U.S. Government. One subject to be investigated is how the interests of U.S. users of steel, including many industries which themselves face foreign competition, can best be correlated with the interests of U.S. producers in these international steel arrangements.

Rapidly rising construction costs have been a serious concern for the past 2 years. In 1969 the Administration took steps to reverse price increases in lumber; the impact on construction is one reason for concern about steel price increases. The Administration has also moved to check the extraordinary wage and price increases in the construction industry. The wage increases have been occurring despite high unemployment in the industry. On January 18, 1971, the President met with leaders representing construction workers and employers and asked them to submit a plan for stopping the exceptionally large wage and price increases that are raising the cost of new homes and other buildings and causing unemployment in the industry itself. An effective resolution of these problems by parties in the industry would avert the need for changes in the legal provisions affecting the construction labor market. The public interest cannot condone continuing massive increases in these costs at a time when American families need more homes and many in the industry are unemployed and need jobs. The rising demand for houses, highways, and buildings must produce more construction and not be dissipated in higher costs and prices.

To regularize the increasingly active Federal role in particular labor or product markets, the Council's function of alerting against inflation has been broadened. By a decision taken in January the Council of Economic Advisers will report immediately to the Cabinet Committee on Economic Policy on any exceptionally inflationary wage or price developments so that the Cabinet Committee can consider appropriate Federal action.

The measures the Administration is taking will contribute to the capability of the economy to resist inflation as it moves along a rising path in 1971–72. They will not relieve the country of the consequences of past errors which have caused us to live for a longer time with both more unemployment and more inflation than anyone would like. They will still leave us dependent upon a course of steady but not excessive economic expansion as the way out of this dilemma. But they give the Nation additional assurances that 1971 can be a year not only of diminishing rates of inflation but also of rising employment and output.

THE PATH OF THE ECONOMY IN 1971

Some of the factors that will determine the course of the economy in 1971 are present and visible, others may be present but not now clearly seen, and still others are, from the standpoint of the Federal Government, matters of policy still to be decided or at least subject to revision.

The most obvious of the present conditions is that the year 1970 ended with unemployment in the neighborhood of 6 percent and output in the fourth quarter about 6½ percent below its potential. As explained in Chapter 1, the fourth quarter was significantly depressed by the automobile strike. This carries with it the probability of a large rise in output in early 1971 to rebuild inventories and meet customers' demands for motor vehicles. Also, apprehension that there may be a steel strike after midyear is likely to cause some larger than usual additions to steel inventories in advance. These two factors will provide a special boost to total output in the first half of the year but they also involve the danger of a subsequent letdown. The assurance of a reasonably smooth and even expansion throughout the year must be a special concern of economic policy in 1971.

Aside from these transitory influences, there are several conditions that promise a strong rise of output during the year. The sharp rise in housing starts which occurred in the second half of 1970, the large inflows of savings into thrift institutions in the same period, and the beginning of a decline in mortgage interest rates all point to a much increased rate of residential construction in 1971 as compared with 1970. How fully these promising developments translate into more housing and more jobs will depend heavily on progress in stabilizing labor and other costs in the industry.

The increased availability of funds and lower interest rates, especially during the second half of 1970, permitted State and local governments to increase their borrowing substantially, and this will support an acceleration of State and local expenditure.

On the other hand, the most recent survey of anticipated plant and equipment expenditure of business, made by the Department of Commerce and the Securities and Exchange Commission in late November and December, suggests a year-to-year rise of 1½ percent. This does not allow for 1971 business purchases of automobiles and trucks not bought in 1970 because of the strike. It also does not allow for the effects of the liberalization of depreciation allowances for tax purposes that was announced in early January 1971 and went into effect retroactively to January 1. This liberalization will initially add about $2.6 billion in calendar 1971 to the after-tax cash flow of business. It will stimulate investment by increasing the after-tax rate of return on machinery and equipment.

The catch-up after the auto strike and the stocking up in anticipation of a steel strike are likely to lead to a high temporary rate of inventory accumulation in the first half of 1971. Apart from this, however, there is nothing in the relationship between inventories and sales as the year opens to suggest that a change in the rate of inventory accumulation will be an active element in the economy for the year as a whole.

The Federal Budget proposed by the President implies an increase of $17.0 billion in expenditures on the national income accounts basis between calendar 1970 and calendar 1971. Federal purchases of goods and services would decline $1.9 billion, the reduction in defense spending more than offsetting a rise in nondefense purchases.

The first instalment of revenue sharing together with other programs would result in $6.6 billion of increased grants to the States, and these will support increased State and local expenditures. Also, there would be an increase of $12.0 billion in transfer payments to individuals, resulting in part from a proposed 6-percent increase in Social Security benefits effective January 1, 1971. On the other side of the Budget there will be the reduction of revenues resulting from the depreciation revision.

There is, of course, no counterpart of the Federal Budget to represent the probable course of monetary policy during 1971. In practice one of the important features of monetary policy as an instrument of economic stabilization is its capability for being adapted quickly and flexibly to emerging developments. As a basis for considering what the outcome for the year would be with a specified combination of policies, it is convenient to assume that the money stock will continue to grow at about the rate that has prevailed since the turn early last year.

There is little doubt that this combination of conditions and policies will bring forth a substantial rise of total output during the year. But the *rate* of expansion is critical for attainment of the Nation's economic goals, and this rate is uncertain. The outcome will depend upon the level of personal savings, the response of business investment to an actual upturn of sales and profits, the effects of rising construction costs on the housing market, the influence of the depreciation reform on business planning, the degree to which individuals and businesses want to rebuild their liquidity, and many other factors. The combination of such variables will determine whether, under present policies, there is a vigorous cumulative cyclical recovery such as has occurred after some economic declines or only a gradual rise.

There is a considerable body of opinion that expects the gross national product for 1971 to be in the range between $1,045 billion and $1,050 billion, which would be an increase of 7 to 7½ percent above that for 1970. This is a possible outcome. However, it seems more likely that with present policies the outcome would be higher than that and could be as high as $1,065 billion.

A $1,065 billion GNP for 1971 would be consistent with satisfactory progress towards the feasible targets suggested above—that is, towards an unemployment rate in the 4½-percent zone and an inflation rate approaching the 3-percent range by mid-1972. This calculation involves estimates of the rates of increase of productivity and the labor force, which may in fact turn out differently, so that the connection between the unemployment-inflation targets and the 1971 GNP is not a rigid one. Nevertheless, although emerging information may later suggest a different view, the figure of $1,065 billion for the GNP in 1971 is an appropriate intermediate target of a policy whose ultimate goal is not a dollar total but a desired behavior of prices, unemployment, and real output. It is reasonable to expect that with an increase of the GNP to $1,065 billion in 1971, the rate of price increase would be declining through the year, the unemployment rate would also end the year significantly lower than at the end of 1970, and real output would show a strong gain.

For the GNP to reach $1,065 billion in 1971 would require an increase comparable to the increases after the low points of the economy in 1954, 1958, and 1961. If the rise in the money stock were to continue at the 1970 rate, the ratio of money to the GNP would then decline at about the average rate of the period 1952–70. Although this is a possible development, it is not a certainty. In the earlier recoveries cited, a major stimulus to the sharp rise of demand and output was a change from running down inventories to building them up. This is less likely in 1971 than after the earlier adjustments, which were much more severe.

A GNP in the neighborhood of $1,065 billion in 1971 is a good present estimate of the figure consistent with the targets for unemployment and inflation. It is feasible, and its realization with the proposed budget and complementary monetary policy is a reasonable expectation.

It will be necessary to maintain an appropriate balance between our international responsibilities and domestic objectives of economic policy in decisions about how to combine or "mix" the different instruments of policy. And the economy remains a highly complex system which, even with its patterns of regularity, does not respond to policy changes in simplistic and invariant ways. For these reasons we must be prepared, as new evidence appears, to make promptly the necessary policy adjustments.

The President's Budget for 1972 is based on the principle that expenditures should not exceed the revenues that the tax system would yield under conditions of full employment. This is an important principle. It permits the Federal budget to support the economy when the economy is weak, by allowing the Federal budget to move into a deficit under those conditions. But it retains the fiscal discipline of budget balancing by drawing a line beyond which expenditures may not go without tax increases. Moreover, keeping the full employment budget balanced, even when the economy is below full employment, prevents the Government from incurring commitments to higher expenditures and lower taxes that would unduly encumber the future. The Budget for fiscal 1972 provides for the most urgent needs that should be met through Federal expenditures. Moreover, the yield of the present tax system will be required later to meet foreseeable expenditures to which the Government is already largely committed. Therefore, still further increases of expenditures beyond this Budget or cuts in taxes would not have been consistent with fiscal discipline.

In the past year monetary policy has moved towards a greater degree of stability in the rate of increase of the moneary aggregates, notably the stock of currency plus demand deposits. This is, as was stated in last year's *Economic Report of the President,* a desirable direction. The financial and economic system is thus given a more stable monetary framework within which to operate.

The reasons for a new stability in fiscal and monetary policy are weighty. But the need to press forward to reduce unemployment and inflation is also great. After the economic instability we have experienced in the past 5 years the parameters of the system cannot be located with precision and may well be in flux. It would be unwise to try to freeze a course of policy which is expected to carry us through the difficult months ahead without change. A course of flexibility and determination, with cooperation and division of labor among the several instruments of economic policy, will be needed, and if followed will lead to the goals we all seek.