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Production
Prices
Pay
Productivity
and
Profits

Remarks

of

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Member
Board of Governors
of the
Federal Reserve System

At a
conference on

Phase I to Phase II:
The New Economic Policy in Transition

Presented by
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I am glad to have this opportunity to speak to a joint labor-management conference. We are in the midst of major new economic developments with tremendous potential impacts on the nation's and our individual future. The interests of each of us as individuals, of all of us as a nation, and of many other nations, are all heavily involved.

Success or failure will depend primarily upon how, at this juncture, we make use of an old American idea: those policies are best for each of us that are best for all of us. That is to say, success or failure of the economic policies we are now embarked upon will depend primarily upon a general willingness to move cooperatively along a path delineated by national goals.

But such cooperation cannot be achieved by begging the fact that in an alert, open, and vital society there is never going to be universal agreement upon what policies, either general or specific, do in fact most accurately serve our individual interests. On the contrary, criticism and disagreement are not only to be expected: they are vital. They are necessary in order to clarify issues and to provide solutions that take into account the genuine divergent problems of individuals, groups, or firms.

What is not helpful, and will not work, is disagreement frozen into polarization. Such rigidities need not follow from the fact that some of you represent labor and some management. The national interest clearly does not require that either management or labor even partially abandon its role. The two represent differences of interests that are both real and important. Consequently, each should be heard distinctly in the dialogue that will shape the outcome of the policies now being put into practice. Labor should continue to speak as the expert on, and advocate for, workers. Management should continue to speak as the expert on, and advocate for, the uses of capital. But--and here, as I see it, is what makes vigorous difference compatible with productive cooperation--labor can--and should--speak for labor in the context of national goals, and management can--and should--speak for capital with national goals in mind.

The Goals of Policy

In order for partisan defense of real and important differences to be tempered into working collaboration through inclusion of the national perspective, we need to be guided by a full understanding of the national goals as they have been set before us.

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Today, my primary aim is to examine the internal logic of the apparent path to these goals. Each of you can then judge whether he believes the assumptions underlying the programs are or are not likely to work out, and if not how he thinks they will vary.

The goals of the New Economic Policy are (1) to raise real output, thereby lowering unemployment; (2) to lessen price increases; and (3) to do this equitably by minimizing undesirable income redistributions. Correction of the balance of payments is a related but separate goal that must be left for discussion elsewhere. Suffice it to say here that all of the international objectives which are the external counterparts of our internal goals will be well served by success at home.

I think the interrelation of the national goals of the New Economic Policy can be best expressed through the five P's I have used as the title to these remarks--"Production, Prices, Pay, Productivity, and Profits." How do they relate to the goals? Output in real terms and jobs will rise with Production. The rate of increase in Prices must decline into the 2 to 3 per cent sphere, even in the face of increased economic activity. This is possible only if Pay and Profits corrected for changes in Productivity raise costs by less than the 3 per cent limit. Furthermore, their relationship to Prices must be such as to maintain both equity and a sufficient demand to call forth the desired increase in Production.

It is this basically simple, but fragile and subtle, set of relationships and cross-connections that we must understand. I have started by sketching them in this general way because the first and most important thing to understand is that these five basic factors are inextricably bound together. Each influences all the others directly and there are feed-back relationships among them all.

Let me turn now to a more detailed consideration of these elements of the economic equation and of their importance to one another, prefaced by a brief look at where we stand just now.

The Current Consensus Forecast

I carefully avoid putting myself into a position where, as a policy maker, I would have to strive to validate my own public forecast. Therefore, I am not going to offer any inside information or even my own personal views in this presentation but simply my interpretation of what the consensus of economic opinion seems to be about 1972 in light of the initial regulations approved by the Price Commission and Pay Board. I might note parenthetically, in defense of consensus economics, that the consensus forecast for 1971 appears to have been excellent--very close for total spending, but too low for price increases and therefore slightly too high for real output and too low for unemployment.

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We must recognize, of course, that the generalized consensus forecast for 1972 is still in the process of development. The forecast is tentative and may alter a good deal in the next 10 weeks. It cannot take final form until the debate immediately following the submission by the Administration of the 1972 Economic Report and 1973 budget. During this period, both the overall forecast and its components are likely to change.

The prevailing consensus predicts that in 1972 the current dollar gross national production will average $90 to $100 billion more than in 1971--a rise of roughly 9 per cent. Furthermore, about 6 of the 9 per cent will come from higher real output and 3 per cent from price rises as measured by the GNP price deflator. This two-thirds, one-third division would almost reverse this year's experience, when, even with the price freeze and NEP since August 15, over 60 per cent of spending has been dissipated on higher prices.

Given conditions expected at the start of 1972, a 6 per cent growth in real output would translate roughly into a 5-1/2 to 5-3/4 per cent average rate of unemployment for the year. Unemployment does not decline by the same percentage as output rises because the labor force increases and because greater productivity raises the amount produced with a given labor force. The rate of increase in productivity, therefore, influences the level of unemployment as does the number who, having left the labor market because of a lack of jobs, return as output expands. Those who are both optimistic with respect to productivity and pessimistic with respect to the extent of current hidden unemployment foresee higher unemployment rates than do their opposites. In either case, by the end of 1972, both unemployment and price increases are expected to be below their yearly averages.

The Major Demand Assumptions

For the expected growth in production to occur, some parts of the economy must step up their spending. Where does the consensus see the newly generated (exogenous) spending coming from to trigger the expected expansion in growth?

--- Consumer durables. The major assumption is that new cars will continue to sell at rates close to recent levels. Sales of other consumer durables are also expected to be strong, aided by new housing production.

--- Housing. Few predict a higher rate of housing starts next year than in the last half of 1971. Most predict a small decline. Still, expenditures on housing construction should

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be higher. Housing construction at the start of a year is related to the starts in the last half of the previous year. Starts in the last half of 1971 are running nearly a third above last year.

--- Government spending. While Federal fiscal policy has not been specified for next year, most economists expect a somewhat larger actual deficit and a movement of the high employment budget from minor surplus to minor deficit. At the same time, state and local expenditures are assumed to grow somewhat faster than recently, moving closer to the average rate of increase of the past few years.

These generating forces together are assumed to lift spending by about $35 to $40 billion with governments furnishing more than half of this total. Of all the above assumptions, that for the level of spending on consumer durables is most critical and least certain.

Other assumptions (also far from certain) concern the reaction of business to the New Economic Programs.

--- Investment on plant and equipment. Because of the reinstated investment tax credit and somewhat greater confidence, businessmen, it is assumed, will increase their expenditures on plant modernization. In addition, plant expansion will occur in certain spheres despite an overall excess of capacity.

--- Inventory investment. More importantly, it is assumed that investment in business inventories will rise towards more traditional levels in relation to sales. Inventory investment is the most volatile of spending streams. Levels have been low for the past two years (although never reaching previous recession minimums). If increased confidence augments the need for higher inventories created by higher output, inventory investment should increase considerably.

The consensus believes that the two sources of business investment together should expand demand by $15 billion.

Finally, the new jobs and additional wages created by this additional spending should induce other expenditures. Consumers would spend more on nondurable goods and services. Such spending expansion should parallel the rate of increase in income. When this new consumption is added to the previous figures, the total increase in spending would be $90 to $100 billion above 1971.

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The Division of Spending Between Output and Prices

There is a good deal less agreement among economists as to how much of the expected increase in spending in 1972 will be translated into effective demand for increased output and how much will simply cover rising prices. For this analysis, two major givens are the 5.5 per cent pay standard maximum and the 2.5 per cent price standard. Questions concern the logic of their relationships, their equity, and the extent to which they will be enforced. How closely will actual average compensation and average price increases compare with the standards?

Actual compensation will, of course, differ from the 5.5 per cent wage standard. Some wages and benefits will rise less than the standard, either because they moved more rapidly than normal in recent years, or because they are in industries with below-normal productivity gains, or with wage-earners in a weak bargaining position. Others will move more than the standard, because of existing contracts or equity catch-up considerations. In addition, average compensation will rise because a higher share of increasing production is likely to be in higher-wage industries and because some overtime will be added.

A second critical question is the impact of increases in production on productivity. In past recoveries from recession, increases in productivity have greatly exceeded the long-run trend. Unchanged wage and salary costs are spread over more units of production, while additional labor is used more efficiently. With this record, estimates of increases in output per manhour for 1972 range between 3.3 and 3.8 per cent, compared to a norm of 2.5 to 3.0 per cent. The consensus probably falls at 3.5 per cent. This assumes that some of the low productivity gains of the past few years will be made up.

The consensus forecast assumes a rise in profits in 1972 of 15 to 20 per cent. This would make profits' share of income about the same as in 1969, but a good deal less than in prior years. Because profits are a residual influenced by all sorts of diverse factors, they are extremely hard to predict. They depend on the accuracy of all the other assumptions as well as on how effective a job each firm performs. So far this year, the rapid rise in corporate profits has carried them to previous highs in dollar amounts although as a percent of GNP and of sales they remain low compared to past periods.

A general view would seem to be that the 5.5 per cent wage standard may translate into a 6 per cent rise in actual compensation. If compensation rises by 6 per cent and output per manhour by 3.5 per cent, then unit labor costs would increase by 2.5 per cent. This undergirds the logic of a 2.5 per cent price standard, together with higher profits.

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The fact that prices rise on the average by the same amount as unit labor costs--2.5 per cent each--does not, of course, mean that profits cannot rise. As production rises there are normally two sources of additional profits. Even with the same profit per unit, each additional unit sold adds to the profit total. Furthermore, profit per unit should rise. Some additional production can take place without adding to plant or other overhead. Thus, total cost per unit falls. The price standards apparently attempt to insure that some of the profits from this second source are utilized to cover added costs of labor and materials.

Spending, Prices, and Production

Having examined the various parts of the consensus forecast and stated the basic assumptions of a 9 per cent increase in spending divided 6 per cent to output and 3 to price, we may check its internal consistency through the relationships among the five P's. To what extent the increase in spending calls forth new production or covers price rises, depends on the effectiveness of policies influencing prices and pay and on the rate of growth of productivity.

Let us therefore re-examine the assumptions and their relationships.

--- Pay. Let it be assumed that the 5.5 per cent pay standard is maintained firmly. Compensation per manhour would rise by 6 per cent, or slightly faster than wage rates.

--- Productivity. Increasing output plus the drive of firms to improve operations and control costs lead to a 3.5 per cent increase in productivity.

--- Prices. A 6 per cent increase in compensation per manhour, less a 3.5 per cent increase in productivity, means that unit labor costs rise by 2.5 per cent. The GNP price deflator will rise somewhat faster than unit prices because no productivity increases are allowed for governments and because of other index number problems. Thus, a price standard of 2.5 per cent on average is compatible with a 3 per cent increase in the GNP deflator.

--- Profits. If prices and unit labor costs were to rise to the same degree and real output rose by 6 per cent, profits would rise rapidly. The price standards appear to call for prices rising somewhat less than costs. Still the rise in output would bring record total profits sufficient to insure that the initial spending forecast for 1972 can prevail. Profit margins, however, would still be below most prior recoveries.

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--- Production. If spending rises by 9 per cent and prices by 3 per cent, then real output would rise by 6 per cent, completing the logical circle.

Clearly, the fact that the consensus forecast is internally consistent does not guarantee that it will be correct. Its accuracy depends upon a long list of assumptions many of which may turn out to be wrong.

However, as new information unfolds, each of us can use these internal links among the five P's to alter any of the assumptions and thereby to arrive at new projections.

Money and Credit

Finally, I suppose it is only proper that I not neglect the implications of this forecast--which I stress is my reading of the consensus, not my own forecast--in the monetary and credit field. Given the consensus assumptions and the goals of overall policy for achieving greater output and less inflation with equity, what monetary and credit conditions appear compatible?

Three rather distinct approaches currently are being used in attempts to analyze this problem. The first looks primarily at money. It asks, given the probable demand for money, if spending increases 9 per cent, what monetary supply would be necessary to maintain interest rates at or below the 1971 levels? Is such a supply compatible with the general goals?

A second approach asks what are the expected changes in saving and investment given the projected changes in spending? Are these compatible with current interest rates?

A third approach concerns the supply and demand situation in financial markets. It asks whether shifts among various groups who borrow or supply credit are likely to lead to changes in interest rates.

At the moment, the consensus seems to agree that none of the three approaches need result in an excess demand for money and credit. In the monetary sphere, the assumptions are not incompatible with the goals of current policy.

Money supply. When past relationships between growth in money and spending are compared to the desired increase in spending for next year of at least 9 per cent, it appears that--whether on a naive basis of velocity and spending trends in the past five years, or through more complicated econometric models--the increased demand for money (M_1) should rise by at least 7 to 9 per cent in 1972, while the increased demand for

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money (M_2) should rise by 9 to 14 per cent. Since monetary relationships are actually more complicated than most simple monetary models suggest, this predicted demand should be adjusted to account for movements in interest rates and in price expectations. The net effect of such adjustments would probably be to lower the demand estimates somewhat.

As a result, the consensus analysis appears to predict a need in 1972 for growth in M_1 of 6 to 8 per cent and in M_2 of 7 to 12 per cent to meet the basic goals of the NEP. No part of these ranges seems to create any basic problem for monetary policy or the money supply.

Savings and investment. Similar conclusions arise from an analysis of savings and investment. From this point of view, one must ask, does the consensus forecast contain such sharp movements in investment, the government deficit, or personal saving as to indicate a need for higher interest rates so as to bring the separate schedules into equilibrium? The answer seems to be "no."

Personal and business saving this year are expected to total about $175 billion. In 1971, sharp increases in housing investment and the Federal deficit have been accompanied by below normal increases in business investment. The moderate increase in total investment has been matched by large increases in personal saving.

Under the consensus forecast, business investment will rise faster next year, but the increases in housing and the government deficit will be smaller than this year. Corporate profits will rise very rapidly. The 4 per cent dividend restriction will insure that most of this increase is saved. At the same time, personal savings and depreciation allowances will grow somewhat more slowly. Again, however, expected changes are not large compared to total savings and investment. The consensus sees no problem of an excess demand for investment which would require sharp changes in interest rates.

Supply and Demand in Money Markets. The markets finance a great deal more than current investment. Firms borrow to increase their liquidity. Others shift their financing from banks to other lenders. Treasury bills held as monetary reserves of foreign central banks may be sold if private holders transfer funds back to the U.S. The Treasury may alter the length of its debt structure. Families may refinance mortgages or borrow to buy existing structures. Any or all of these shifts can cause movements in individual interest rates. These may in turn raise or lower the entire structure of rates.

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Again, when one examines the list of changes in the financing structure that is implied by the consensus forecast, they seem to be those which a system with a growing stock of money and savings should be able to handle without much difficulty. Many believe that corporations have restructured their liabilities to such an extent that long-term corporate debt will rise less next year than it did this year. Corporate saving with higher profits and limited dividends should expand at least as much as new investment. The housing market will seek more funds for new construction, but the big shifts have occurred in mortgages for sales and refinancing of existing structures. Since those who receive these funds must in turn place them elsewhere, any problem would arise only if they placed their receipts outside the usual rechanneling institutions.

A concern has been raised over the fact that a large share of this year's large Treasury deficit has been financed primarily by increases in foreign central bank holdings of U.S. Government securities, and that these flows might reverse. This year's inflow did raise the demand for short-term bills and as a result they are selling at relatively lower rates than other money market instruments. A reversal of this year's flows would cause a reversal in rate relationships between bills and other short-term instruments but the difference would not seem great enough to cause any major disruption.

On the whole, the total volume of funds raised next year should increase but probably not by as much as either income or savings. This year funds have been adequate. The financing "residual" implicit in the consensus forecast for next year appears to be well within a range which past experience suggests can be handled without a substantially different interest rate structure.

Conclusion

The goals of policy now being initiated, as generally understood, then, would appear to be in themselves internally consistent, and to be realizable without placing undue strain upon the money markets or monetary policy. All this, however, I would repeat, hangs upon a single assumption. This is, that the goals of policy as now stated will remain our national goals, that they will not be eroded or jostled out of their present harmony and general practicability.

Is that a good assumption? This is the most important question of all, because all other assumptions fall if this one gives way underneath them.

I will try to answer, not in terms of a prediction, but in terms of possibilities.

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First, I think we should all be clear beyond any possible doubt that the goals of the New Economic Policy cannot be "enforced." Every experience we have ever had in this country, and every comparable experience I know of elsewhere, shows that whatever plans of economic policy human ingenuity can envision, and whatever schemes of enforcement can be devised, other human minds are ingenious enough to get around, overturn, and defeat them in short order, if those bent upon their destruction have the support of public opinion.

Second, it should be equally clear that there is a corollary to this: To have not only economic growtn but also economic balance and order, we, as a people, must desire such results. If we do, we can successfully create economic policies to achieve these desires.

The fact that no far-flung bureaucracy is being recruited to "enforce" the controls and guidelines that are now our economic parameters should not be alarming. If such a bureaucracy is needed the policies it comes on to enforce cannot succeed; for those policies to succeed, only enough of a bureaucracy is needed to devise reasonably equitable rules of the game, keep them current, and explain them.

We can conclude, then, that it is possible for the New Economic Policy to succeed.

Whether it will in fact succeed would seem to boil down to a single question: Are the rules of the game now being handed down and put into practice, sufficiently equitable to inspire a general desire among us for them to succeed, or, if not so at first blush, do we have the will to alter them in ways that will put the great power of public desire behind them?

Once again, I would answer in terms of possibilities, and, in those terms, the answer is certainly "yes." It is possible for us to devise and hold to a pattern of economic good behavior that will unite us generally in the conclusion that growth without corrosive inflation is the most desirable type of growth. From such a pattern, each of us can benefit most both in output and jobs and in equity. If we are convinced of this, it will be very hard to keep us from succeeding in our aims.

This requires, not that any of us sacrifice our identities, our expertise, or our belief that our own point of view--as farmers, professionals, public servants, businessmen, labor organized or independent, and on down the corridors of our many ways of life--is valid. Success requires only that we do not consider our own view the only valid one, that we hold fast to the principle, which is perhaps more typically American than any other, and that I have already mentioned: those policies are best for each of us that are best for all of us.

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The views of management and of organized labor, their interests, and their differences are, as I have noted, genuine and important. But their aims can be achieved only in the context of an economy that gives due regard to the relationships of all five of the fundamental variables I have stressed: Production, Prices, Pay, Productivity, and Profits. A balance among these factors is the basis of national economic success, and understanding of how they relate to one another is fundamental to achieving our goals.

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