For release on
Wednesday, August 12, 1970
at 2:00 p.m. EDT

Forecasting Economic Activity in 1970

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at the

Denver Economics Club

Denver, Colorado

August 12, 1970

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Economic prospects today are more shrouded than usual in uncertainty and apprehensiveness. Uncertainties are manifest in the violently fluctuating expectations of investors; they are also evident in the relatively low rates of spending by consumers. Apprehensiveness is apparent in the widespread doubts within business, political and financial circles as to the efficacy of monetary and fiscal restraints in bringing prices and costs under control without inducing a serious recession.

The present environment, in contrast with that prevailing in the Sixties, has some unfamiliar patterns--while the "go-go" is no longer with us, the aura of a Fifties-type recession has not returned either. We are living in a kind of surrealist stillness, in which the economy respires but does not otherwise move--a dangerous state in which to linger too long.

What has happened to cause consumers to break their long-established peacetime consumption patterns? Vietnam did not divert much, if any, production from consumer output but Vietnam did alter consumer attitudes toward spending and saving. The extreme posture of anti-consumerism--so much in the news lately--is held by only a very small part of the population, but the environment which produced it has, in a less spectacular way, weakened consumer demands on a much broader front. Consumer concern about inflation seems to have had an adverse effect on spending over and beyond necessitous retrenchment by those living on fixed incomes. Recently, concern about income prospects also appears to have brought about more conservative spending attitudes. Our youth have shown no more inclination to spend freely than their elders. Disenchantment with the ultimate goals and the structure of society has not stimulated their consumption, either; neither their concern nor their protest appears in our calculation of the gross national product.

Attitudes generally have been buffeted by non-economic forces--the ups and downs in our progress toward disengagement in Vietnam, the tensions introduced by social and student unrest, and the uneasiness of so much questioning of our society's goals and the establishment's institutional arrangements for meeting them. One might epitomize the worrisome mix of economic and non-economic trends in the past few months by observing it's been a tough time for both ticker tape and girl watchers with plunging stock prices and hemlines.

Uncertainties of the type I have been mentioning, by altering the psychology and attitudes of consumers and investors, influence their spending and investment decisions. But since the underlying forces are essentially non-quantifiable, directly or through proxies, the timing, duration and magnitude of these influences are not readily incorporated into econometric models on which we have become dependent.

Dependence on the models is not misplaced. Their capacity for internal consistency, for bracketing the forecast range, for policy simulations, and for objectivity are invaluable aids to economic forecasters. Edward Gramlich, an econometrician on the Board's staff, put it well recently:

"Judgmental forecasts may be consistent in the sense that all identities add up correctly, but they are not always consistent in the economic sense that consumption patterns may not be consistent with inventory patterns, or that flow-of-funds projections imply interest rate patterns which are consistent with the patterns of final demand. Model forecasts, whatever their defects, insure this consistency automatically." Within, I would add, the range of past experience.

"Secondly, model forecasts can increase the mechanical advantage of judgmental forecasters. Rather than having to appraise major economic relationships and specific factors simultaneously, models can take care of the major economic relationships and allow judgmental forecasters to worry exclusively about specific developments. Thirdly, a close study of the residuals might itself be instructive because it acts as an early warning device in noting instances of structural change in economic relationships. Fourthly, models provide a technological advance in that once a forecaster has adjusted residuals to give reasonable predictions, he can at zero cost extend his forecast further into the future and alter policy variables to examine the effects of policy changes. And, finally, the model gives the forecaster an independent and completely honest check on his judgment."

Mr. Gramlich stresses the strengths of the econometric approach but the prestige of this technique can be misused. For example, there is some tendency for sorcerers' apprentices to use simplistic models to simulate nightmares for policy makers, by projecting intolerable levels of inflation or unemployment, or even both! In the hands of the master economist, models greatly extend insight and usefulness. A master does not hesitate to adjust judgmentally the model's workings and findings in light of known weaknesses or those that come to light, and he does not needlessly stir up policy makers.

In the current environment the greatest difficulty of the model user seems to me to be found in evaluating consumer demand, appraising the effect of the recent large decline in equity values on consumer demand, housing, and business investment. Models in use are not adequately equipped to deal with the abnormally large changes that have occurred in financial asset values or with the historically unprecedented level of interest rates at which funds must be obtained.

Under the circumstances, I find it difficult to achieve a high degree of confidence of forecasts within the range of projections that are offered for GNP, real GNP, the unemployment ratio, the GNP deflator and other stripped down indicators of the economy's performance. No do I sleep much better at night knowing that the money supply in the first half of the year grew at the magic rate of 4.0 per cent, since it may well be that demands for cash balances in a time of uncertainty changed by much more than this. But some people do.

Money supply watchers these days are almost as numerous as ticker tape and girl watchers. As a technique of business forecasting it supports a broad range of applications and devotees. It is simple enough for dilettantes and can be made complex enough for erudition or darkly obscure mysticism. And it can also be adapted to policy making or to second guessing the decisions of policy makers.

The basic difference between the econometrician and the money supply watcher is that the former seeks an explanation of the process by which changes in the various sectors of the economy occur. The money supply watcher, on the other hand, professes little or no interest in that process--it may be too complicated to unravel or it may simply be irrelevant to the purpose. The relationship of changes in money and changes in economic activity in the past demonstrates--the dogma goes--that with a lag, the changes in business activity will respond to changes in the rate of growth of money. But in this simplistic approach lies the danger that the past relationships may not hold, or that the sub-structure of the relationship will hide economically meaningful differences. Even if a change in current dollar GNP lags predictably behind money supply developments, for example, the share of the GNP that is real and the share that reflects price increases may well shift with economic attitudes.

While my preference is for econometric analysis of the more substantive variety, I fully agree that the relevance of monetary and credit aggregates as proxies, responders or generators must not be ignored. Monetary policy making is better for giving more attention to the monetary and credit aggregates. But without some theory of relationship between money, however defined, and the economy, confidence in a particular regression result tends to become an act of faith in light of the unlimited possibilities of alternative regression findings derived from alternate definitions of money, varying time periods of lag, and different paths through which the monetary influences may work themselves out in different economic circumstances.

Another limitation money supply watchers should bear in mind is that no single aggregate merits consistent allegiance as the economy's financial needs and practices change, or as bankings' share of credit flows change. This fact is well illustrated by the 1969-70 experience with the use of Regulation Q ceilings, constraints on repurchase agreements and other devices adopted by the Federal Reserve to limit if not sever bankings' connection with money and capital markets. These measures made M_2 and the credit proxy, in my opinion, inappropriate measures of monetary conditions. Their relevance, even with the adjustment of the proxy for Euro-dollar use, loan sales and the like, requires the assumption that limiting the impact of monetary restraint to the banking system while leaving funds to flow more freely in direct credit market channels, somehow administers the monetary coup de grace. Bankings' share of the market declined dramatically during this period but because of extensive disintermediation comparable restraint was not applied to the economy as a whole. Most of the proponents of M_2 as a significant monetary variable discontinued reliance on it during the period in which banks were forced to limit their access to U. S. money markets.

Under those circumstances, M_1 has recently been the focus of most money supply watchers. And it has put on quite a pyrotechnic display for them--particularly those who believe that a week or month of rapid rise or decline, measured in terms of annual rates of change, presages more of the same. To a significant degree these explosive changes have been due to imperfections in the basic statistics obtained in the course of estimating net IPC demand deposits. But if this limitation had been overcome there still would have been an irregular growth in the money stock on a month-to-month basis and some money supply watchers would have been able to view developments with great alarm by peak-to-trough or trough-to-peak measurements. Considering the data problems and the System operational techniques money supply watchers would do better to take another look before reaching a judgment they must shortly reverse.

In the record of the past 12 months the monetarist would--in my judgment--have had little to disturb him had he taken a longer look and a more discriminating one at the actual data:

	Annual rates of change	
	Monthly	Quarterly
1969----July	1.8	
August	-1.8	0.0
September	.0	
October	.6	
November	1.2	1.2
December	1.8	
1970----January	9.0	
February	-10.7	3.8
March	13.2	
April	10.7	
May	3.5	4.2p
June	1.8	
July	4.1p	

My judgment over the year as manifested in my voting record was that, with one exception, the money supply aggregates have been appropriate to actual conditions. In the late summer of 1969, however, monetary conditions were getting too tight as evidenced by the behavior of M_1, as well as by the further rise in long-term interest rates at a stage that was obviously very late in the cycle. A majority of the FOMC did not agree that these trends indicated further tightening and stated in the directive the intent to maintain "prevailing firm conditions in money and short-term credit markets." Governor Maisel and I were the only members of the Committee at the meetings of August 12 and September 9 to contend that a "no change" directive in terms of money market conditions would, in fact, be a tightening directive.

Short-run money supply trends in January, March and April of 1970 were not indicative of longer run M_1 trends, as subsequent developments have indicated.

In recent weeks, liquidity stresses in the economy have been eased without any great change in M_1 or its components. But there has been a great increase in intermediation at commercial banks and savings and loan associations. Large denomination CD's, freed of ceiling restraints in the important maturity ranges, rose about $1 billion per week for five successive weeks. Total time and savings deposits at commercial banks rose at an estimated annual rate of 35 per cent in July and re-intermediation, along with discount window accommodation, made funds available to banks who, in turn, accommodated those sectors of the economy under liquidity stresses.

In June-July some observers thought that liquidity demands of the economy would require large changes in M_1 which, on the basis of some model projections, would lead to resurgence of inflation. It now appears that the liquidity crisis was not a problem of the economy as a whole but only of limited sectors. Nor do data available up to this time indicate much net effect on M_1. The most recent evidence of behavior of money holders shows them exhibiting a strong preference for the convenience, safety and liquidity of near monies--high quality, short-term securities or interest-bearing time deposits.

These shifts seem to be at the expense of equity holdings, riskier investments and consumer expenditures.

The cooling-off process initiated by a combination of monetary policies nearly two years ago was described at the time as "gradualism." The gradualist approach was derided by some as ineffectual but, with some fortuitous assists, it has turned out to look pretty good. It has slowly but spectacularly altered economic expectations and business prospects. It has set in train a sequence of events which will, given still more time, bring inflation under control. It has uncovered weaknesses and abuses in credit practices and financial structures that are characteristic of an inflationary environment. These are now undergoing correction and modification, but in an orderly way and without aspects of cumulative over-reaction by lenders and investors.

The processes set in motion have yet to run their course in the effects on prices and costs. But the policy issues of the moment are not those of sustaining restraint until the last ripples of earlier inflationary programs and policies have died away. Rather, the issue is one of timing action to stimulate those sectors of the economy on whose activity we will be dependent for jobs and opportunities six to nine months hence. Since we have limited experience with the conjunction of a dramatic decline in wealth, a widening recognition of the continuing burden of high interest rates and an economy greatly concerned with non-economic issues, we can easily underestimate the economic contraction that has been set in process, and will need to be reversed. The dimensions of the problem are difficult to bracket and the forecasting complexities in an environment with so many cross currents present are formidable. The experience of the past year or more convinces me, however, that above all we will need a greater awareness of the limitations in our projection techniques if we are to avoid being impaled by doctrinaire monetarist or non-monetarist models of sorcerers' apprentices.