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A PRELIMINARY POST-MORTEM ON THE 1969 ECONOMIC PROJECTIONS

Remarks of

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Just as the Christmas shopping season seems to come earlier each year so does the season for year-end forecasting. The press already speaks of a standard forecast for 1970. Underneath all these forecasts, however, there are assumptions about what fiscal and monetary policy is going to be and how these policies are going to affect the economy. Before prescribing a particular set of policies for next year, it seems a good idea to draw what lessons we can from the outcome of the forecasts for 1969.

Specifically, I want to compare current estimates of how the economy is faring in 1969 to the projections made by the Council of Economic Advisers and by the staff of the Federal Reserve last January. These forecasts are particularly important because they were based on a specific set of monetary and fiscal policy assumptions. The policies adopted for 1969 may be considered to be the scenario or game plan of the fight against inflation.

The aim of these policies was to hold the year's growth in spending to less than that of potential output. It was hoped that a gradual reduction of pressure on resources would lead to a lessening of inflationary pressures. An evaluation of their success or failure is important in the selection of policies for 1970.

First, how did the forecast fare?

... Measured by the demand for real output, this year's results are extremely close to the policy goals. If anything the final demand for real output has grown slightly less than forecast.

... Measured by price changes, policies have been a good deal less successful than predicted. Prices have risen by an extra percentage point above the projections.

Let me anticipate and summarize briefly what these results appear to indicate for next year's policy choices. The divergence between the forecast and results raises important questions about the relationship (or trade-off) between output and price changes. This divergence leads to two very different views as to the proper policies for 1970.

... The first view argues that since the forecasts of real demand were excellent, no change in the underlying assumptions is necessary. Policies for next year should continue on the same path initiated this year. Three problems do exist, but these are not critical and they can be solved.

1. The first problem is to actually adopt the proper monetary and fiscal policies. This was hard to do in 1969, and may prove to be even more difficult in 1970.

2. The second problem is that a continuation of the existing over-all mix of policies is likely to lead to a critically poor period for particular sectors of the economy especially housing and construction. Moreover, a continuation of 1969 policy restraints will result in a considerable increase in unemployment.

3. Finally, many firms appear to have based investment and labor decisions on an assumption that the stated policies of combatting inflation would fail or would be reversed as they became effective. If policies continue on track, there will be excess capacity, lower productivity, and a sharp fall in profits.

... The second view holds that existing policies cannot be successful, as is evidenced by the larger than expected rise in prices. This view believes that new policies must be adopted if inflation is to be avoided. One of two far harsher policy paths than the one now existing is suggested.

1. Cut the demand for resources still further. Some feel that inflation can be halted only by a sharp recession or a depression calling for much higher unemployment rates and a lower level of utilization of plant and equipment and lower profits than is called for under existing policies.

2. Others feel that a rapid rise in unemployment and unused resources is too harsh and inefficient a policy. They argue that cost-push or the price-income spiral must be attacked directly. They want an incomes policy with the form advocated depending upon the individual. Suggestions range from administrative price-wage controls to a return to "jawboning" and the informal price-wage guidelines of previous years.

The Preliminary 1969 Results

We must base our analysis on early estimates of this year's GNP outcome. The most preliminary figures won't be available for three months. Even then they will be subject to revisions far into the future. This is not, however, as unfortunate as it might seem. Policy always must look to forecasts of the future based on rough estimates or preliminary figures for the present. This year's forecasts were based on last year's estimates. For policy purposes, the movements from one set of estimates to the next are probably more important than the changes in the final figures.

The projections for this year by the CEA were for a growth in current dollar GNP of $60 billion to an annual rate for 1969 of $926 billion.1/ My present guess is that we will exceed that forecast by around $7 billion.

In terms of the total amount of production, this is an error of less than 1 per cent. It is one that on the average even the most optimistic forecasters have little hope of beating. In terms of the estimated increase in demand of $60 billion it is, however, an error of slightly over 10 per cent. While many believe this is the error that counts, even a 10 per cent error is not bad. In fact, if grades are assigned based on the estimated change in the GNP, last year's forecasters must be given a rather high grade.

This is particularly true since a sizable part of the error results from current estimates that inventory accumulation will be higher than originally projected. This is a part of forecasting that is notoriously subject to error. Furthermore, it may mean that actual demand was not above the forecast. If producers produced too much, we don't know if inventories are reflecting either a hedge against future inflation or a failure to sell unwanted goods.

The only other significant error on the spending side was in the demand for consumer durables. All other demand misses were minor, although it does appear the year will end with plant and equipment at a somewhat higher production level than had been expected.

As for output and prices, it looks as if the increase in real output will be almost exactly that projected, but the price error will be considerable. The fall in the growth rate of real output to well below potential is significant since it is this gap that is expected to lower

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1/ Based on the level of the current revised GNP estimates.

price pressures. The rate of price increase, however, appears to be about 4.7 per cent as compared to a projected increase of 3.7 per cent. While the error in the price level will be under 1 per cent, the projection error for the increase in prices will be more than 25 per cent. Perhaps more significant the direction of change was missed. A price rise slightly less this year than last was projected. The opposite occurred. Furthermore, the gap between the projection and actual has not been closing. One would not assign a very high grade to the price projection.

An Evaluation

An evaluation of these results can lead to two very different viewpoints. One can take a very optimistic view with respect to the results. An optimist would point out that the errors in the forecasts do not fall outside the normal range expected when the forecasts were made. Similarly, a statistician would note that the figures could not be used to prove that the original plan was not being followed.

This optimistic view would stress that the demand for real output and, therefore, the basic demand for resources seems actually to have fallen below the projections. If one believes that inflation arises primarily from an excess demand for resources, then the goal of a diminished pressure on resources is even closer than the forecasters expected.

This is particularly true to the extent that excess current dollar spending can be attributed to an unwanted inventory accumulation. A period of excess inventory accumulation is normally followed by a rapid decrease in inventory investment. Previous experience with inventory fluctuations leads to the expectation of a compensating decline in the first half of next year.

While the economy has not reacted quite as rapidly to the slower rate of increase in output as had been projected, the slippage is not great. The optimist sees no need to change the basic reasoning or relationships underlying the game plan. It would be proper for next year's projections to assume the same relationships between policy and results that underlie this year's forecasts.

A pessimist could arrive at an opposite interpretation. He could point out that since the policy called for was one of gradualism even a small failure in meeting the forecast goals must be considered serious. The expected reactions were not great. The apparent response is even less. In comparing the actual to the expected gains, the slippage is considerable.

The pessimist would bolster his case by pointing out that the name of the game is really "price-changes" or "inflation." This is the sphere where the major misses occurred. Prices increased 25 per cent more than predicted. An inflection point in the rate of inflation was forecast which did not occur. No deceleration can be found in the data.

Furthermore, this miss occurred with a more restrictive fiscal and monetary policy than was assumed at the time of the forecasts. Government tax receipts ran well above projections. This excess, coupled with a correct forecast of expenditures, has meant a larger surplus. This should have led to a smaller growth rate than was forecast.

That we have a more restrictive policy than originally assumed is even clearer in the monetary sphere. Interest rates are far higher and the flows of monetary aggregates are far lower than had been predicted. As a result, the pessimist points out, it has taken much sharper restrictions than assumed to achieve less than projected actual results. Both errors were in the wrong direction.

The Points at Issue

Without advocating or adopting either of these opposing points of view, I think it worthwhile to discuss some of the reasoning of those who stress the divergences and believe a significant slippage has occurred.

Discrepancies exist between the projected and actual growth in current dollar GNP, resource utilization, and prices. One possible explanation is that the forecasters biased their projections in the direction that would give them hoped-for results. Is the economy actually reacting differently from the past, or did the forecasters assume a more favorable outcome than should have been expected?

While the problems in finding statistical relationships in data are well recognized, a careful examination does not indicate an obvious bias. The projections were internally consistent in their spending, output, and price forecasts. Compared to past relationships, this year's spending would have been expected to produce a somewhat higher unemployment rate and prices about 1 per cent lower than the 1969 level now estimated.

A second possibility is that the forecasters either considered only the problems of demand-pull or assumed that the Administration would strengthen or maintain pressures against elements of cost-push. Those who believe in a price-wage spiral and the ability of large firms and large unions to raise prices and wages faster than would occur in a perfectly competitive economy claim the extra increases in prices which occurred could easily have arisen from the failure of the Administration to adopt any kind of incomes policy whatsoever, particularly since this failure was accompanied by statements of a determination to allow business and unions to set their own prices and wages without any pressure from the public interest.

A final set of reasons advanced for the slippage centers around the possibilities of too little fear of a future depression or too great a fear of future price rises. The point is made that businesses and individuals--skeptical of a real attack by the Government on inflation--have made investment and spending decisions based on lower expectations of future losses than would be consistent with past history.

The major evidence for this point of view is that the spending forecasts were primarily wrong with respect to producer and consumer investment goods. In addition, the failure of unemployment to track real output has been attributed to a tendency to hoard labor. Given past labor shortages and expectations of future shortages without adequate replacements, during this past year firms have been willing to keep their employees on the payroll despite only slow growth in real output, and hence have accepted a sizable decrease in productivity and efficiency.

It is hard to disentangle this argument from the previous one. Were firms convinced that a steady increase in demand and prices would insure them against any losses from over-investment and lack of efficiency? Or did they believe that they could compensate for any investment errors by their ability to raise future prices even if no excess demand existed?

The much tighter than projected monetary policy must also be commented upon. What does the fact that interest rates have been so much higher and monetary flows so much lower imply with respect to the assumed relationships? Here the advocates of the different approaches to monetary policy would also end up with different explanations.

A monetarist or one who primarily stresses changes in the narrowly defined money supply would probably hold that the economy currently displays a deflationary spending bias accompanied by a fear of future price rises. The estimated increases in spending for the year are considerably less than his past monetary relationships would have projected. While the economy evidences a lack of inflationary expectations on the spending side, the high interest rates could reflect a belief by investors in higher prices in the future.

Those who emphasize that money and interest rates work primarily through expenditure decisions would not give much weight to the monetary under-estimates either. They would point out that, because income was higher than expected, interest rates also were higher. (Rates in the short-term markets are not out of line but rates in the long-term markets are much higher than past experience would indicate.) With respect to the interest rate effect on spending, their models would show most of the resulting impact occurring next year and the year after. As a result they could stick with their assumed relationships. The major impacts of the higher than expected interest rates and, therefore, the test of their relationships with spending are still ahead of us.

The Outlook

What lessons can be drawn from this evaluation? Does it aid us in making 1970 forecasts? More significantly, what does it indicate with respect to possible policy choices? New decisions must be made constantly based on an analysis of current projections. What should these decisions be?

Some conclude that the existing game plan is correct. Assuming that monetary and fiscal policies can be maintained so as to keep us along the present path, they would be satisfied. While minor slippages may have occurred, they are not such as to cause them to question the underlying analysis or relationships. The successful completion of the anti-inflationary battle may take a little longer than expected, but it still is in train.

While the tighter than expected monetary policy does not indicate any past error, it does require a projection of where current policy leads. Monetary policy has continued to tighten week by week. If the initial relationships were correct this monetary policy outcome, unless relaxed, would be expected to lead to an accelerating decrease in the demand for real output. This problem is exacerbated because again, if past relationships hold, much of the decreased output would be expected in housing production. This could lead to a reverse inflationary twist by raising rents and the prices of existing housing due to the decline in new housing production.

This specific problem is not, however, inherent or structural. It simply requires that the correct balance of monetary and fiscal policies be adopted. While many believe the wrong monetary and fiscal path is more likely to be picked than the correct one, a proper choice is clearly possible.

The second problem may be more difficult. Firms and individuals have not been adjusting their actions very rapidly to the lowered demand for real output. Higher labor costs have been accepted and new investments made. If the demand for real output continues on or below the present slow growth path, the excessive level of investment must lead to greater amounts of unused capacity, still lower productivity, and a sharp fall in profits.

If investors are over-estimating future demand and therefore are over-investing, when they recognize that the economy is continuing to follow a less expansive growth path they will contract their expenditures sharply. Historically, the extent of their contraction has more than compensated for previous excesses. Most find it difficult to envisage a game plan that allows a smooth reaction to this problem. There is no desire to compensate for past excesses by future ones.

A different view of logical policies is, however, also held by many. They believe the existing scenario must be altered. They feel that the fact that price increases accelerated even as increases in real output decelerated indicates a basic error in the assumed relationships. Just continuing along current paths, while it may cut back demand, will not have the desired effect on prices and inflation. Technically, they believe the amount of unused resources needed in order to achieve slower price increases has been under-estimated.

They argue that if the increase in prices is to be slowed down a change in policy is necessary. One group primarily stresses the belief that this year's forecast was in error because it under-estimated the amount of excess resources required and, therefore, the amount by which demand must be decreased. Based upon their assumed relationship, they believe policy requires a faster fall in demand and a faster rise in unemployed resources, both of labor and of plant and equipment. They may not be happy about the implied unemployment rate, but they are willing to accept it as a necessary evil.

Others, however, feel that the recession or depression which such a prescription calls for is an inefficient method of meeting the problem. They also believe the path is wrong, but they feel that a better solution is to alter directly the trade-off between unused resources and prices. In their view, a minor amount of excess resources could lead to lower price rises, but only if the price-wage spiral and cost-push are attacked directly. This is why they advocate some form of incomes policy.

An increasing number have been arguing for general price-wage controls. Others point out that such an over-all program may not be necessary. If prices are not being pulled up from the demand side, the problem of dealing with price-wage pushes may require a much smaller number of active policies than was true in World War II or even Korea.

The most pessimistic view of all, of course, believes that primarily for political reasons, there is no real desire by Government to adopt a successful anti-inflationary policy or plan. I have no way of judging the politics of inflation or anti-inflation. I personally believe that those holding this view of things to come are probably wrong. People are interested in devising a successful attack on inflation. The decisions required, however, are not at all simple or clear. That is why so many diverse views and policy suggestions are possible.

On the whole, a review of developments in the economy indicates that some progress against inflation is being made, even though that progress is not quite so successful as had been forecast at the beginning of the year. Those who believed there were easy solutions, however, have not been proved right. The lag between changed policies, lowered spending, unemployed resources, and finally less rapidly rising prices has not been shortened. Some feel it has lengthened, but if so there is little proof of much change. It may often seem that a watched pot never boils, even though we all know that this is not actually true!