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Economic Outlook

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The forecast session of the American Statistical Association is a long standing tradition which I suspect is headed for the technological casualty list, for there is nothing about business fluctuations, with which this session is concerned, that is inevitable. The source of over-expansion and over-contraction in the economy is the lack of facts and understanding on the part of businessmen, consumers, and public policy makers.

Not all ignorance and uncertainty can be removed from our activities, but the econometricians, statisticians, and electronic data processors are certainly reducing--or are about to reduce--expendable uncertainty in economic knowledge both for businessmen and policy makers. I am on your forecast session as these technological changes are in process--too soon to deny I have a useful function, too late to pretend the course of events in the coming months will not be modified by private and public policies aimed at averting the very events I am trying to predict. I can only hope that the econometricians will soon get the "preliminary methodological problems" settled and begin estimating real rather than imaginary structural equations; future outlook speakers for this Association will then be obsolescent. For today my remarks will be institutionalist in character with the traditional seasonings of common sense, judgment, and analysis.

Features of Recent Developments

Let me start by briefly reviewing some of the important features of our present economic situation.

Today many commentators on economic trends are pointing with considerable satisfaction to the present cyclical expansion. They can note that in the third quarter of this year, real GNP is some 11-1/2 per cent above the cyclical high of the spring of 1960. This is an annual rate of increase of more than 3-1/2 per cent. It is a better performance than in either 1957-60, or the four years from 1953-1957 when the annual rate of increase averaged less than 3 per cent. Industrial production has risen over 4 per cent a year since the spring of 1960, also a much better record than at any time since the Korean War.

These historical cyclical comparisons are impressive and in some degree properly so. However, the technique of comparison is suspect and admits of so much manipulation that I question whether it should be used at all. If, for example, the results are not proper impressive on a peak to peak basis, one can try trough to trough -- point of inflection to point of inflection--trough to peak--or peak to trough. If these don't work one can refer to the total expansion in a cycle or refer to the average monthly expansion--if necessary on an annual rate basis. The possibilities are such that almost any cycle can be made to look impressively good or bad. This is especially true for a cycle that has not yet reached a peak or trough. I would not go so far as to say that historical cycle comparisons should be shunned, but they should be viewed with considerable skepticism as they are more likely to be soporific than significant for understanding or policy formulation. If one wants to gauge performance of the economy--its action relative to its potential is a better standard. And by this criterion the present output record is lacklustre.

In the postwar period prior to 1958, under-utilization of resources, whether manpower or industrial capacity, was no more than a short-run cyclical problem. Since 1957, however, under-utilization of resources has persisted throughout periods of cyclical expansion. Insofar as manpower utilization is concerned, there is little--or no--sign of imminent improvement. A 5-1/2 to 6 per cent unemployment rate over-all has meant an 11 per cent rate for nonwhites and also an 11 per cent rate for the 14 to 24 age bracket

For next year, the projected labor force increase is 1.0 million: for 1965, 1 5 million, of whom 900 thousand will be young people 14 to 24 years of age. Furthermore, labor force growth has fallen 1/2 million behind projections made not much more than a year ago To use these available labor resources, current rates of increase in output will have to be significantly bettered, no matter how impressive by previous cyclical experience Given the declining participation ratio of labor force to population that has recently prevailed, we should expect that if rising employment demands materialize they will induce a substantial labor force re-entry. This slack will have to be taken up before the statistical evidence of achieving our goal appears.

So far as business fixed capital is concerned, industrial capacity utilization has been significantly below levels prevailing from the spring of 1955 into 1957. Most recently, however, in June and July, following the sharp spurt this year, manufacturing output, according to Federal Reserve estimates, reached 87+ per cent of capacity, the best showing since the spring of 1959. But this is still significantly below the 92 per cent of late 1955.

Another distinctive--and commendable--feature of the years since 1957 is that they have been free of inflationary pressures. Wholesale prices of the broad range of industrial commodities, and prices of the more sensitive industrial materials are, on average, little different today from what they were 6 years ago. It is true that consumer prices have risen a little over 1 per cent a year, but much of the rise is attributable to services. Furthermore, quality improvements in consumer products--and in a wide range of industrial products as well--suggest that official indexes have some upward bias over time.

In manufacturing, unit labor costs are about the same as they were in late 1958, a sharp contrast to the sustained and large increase in 1955, 1956, and 1957. Productivity gains in this expansion compare favorably with gains in other postwar expansions. The increase since the spring of 1960 has been 14 per cent; in the comparable three years or so from the summer of 1953 to the fall of 1956, the rise was only 11 per cent. Another major influence in holding down manufacturing unit-labor costs has been the progressive slowdown in the rate of increase in wage rates and average hourly earnings.

There are, of course, other features worthy of comment. The auto "boom" for the second consecutive year has been exciting to some and has certainly contributed to expansion. In accord with the most recent industry statements, however, I find performance gratifying but hardly spectacular for the 1960's. Seven to eight million units should be the norm for the mid-sixties. But spending for autos and parts--the best publicized of all consumer outlays--nevertheless accounts for only 6 per cent of total consumer purchases of goods and services.

It is hardly news when consumer spending rises--it has risen in 60 of the 66 quarters since the beginning of 1947. It is a record that supports faith in the eagerness of the American consumer to statistically spend most of his income on "current" consumption. For example, we find that consumers spent 92.4 per cent of their disposable income in 1961, 92.4 per cent in 1962, and 92.6 per cent in the second quarter of 1963. These are rates virtually identical to the average of the past decade and suggest that in recent years--as distinct from early in the postwar period and in contrast to the big consumer spending splurge of 1955 relative to incomes--consumers, as a group, have been in a rather stable expenditure pattern.

So far as business spending is concerned, inventory accumulation started unusually early in this expansion period but inventory policies by and large have been on the cautious side. Stock-sale ratios have been and continue low. On the other hand, spending for fixed capital, though showing a cyclical rise and at last exceeding the 1956-57 highs, lags significantly relative to total GNP. It has been for some years--and remains today--a major cause of defaulted expectations for fuller utilization of manpower and industrial resources.

The flow-of-internal funds to corporations has been in record volume and has accelerated recently, rather unusual for 2-1/2 years after a cyclical low. Profits before tax, though lower relative to GNP than earlier in the postwar period have on the whole, with some allowance for the effect of liberalized depreciation guidelines, continued to move up, although irregularly, throughout the expansion; an atypical cycle development. Ample corporate funds have not had the generative effect on corporate spending that is often assumed.

The Short Run Outlook

Let me now turn to the short run economic outlook. For the immediate future, i.e., for some months ahead, prospects are quite good for a continuation of the recent moderate increases in over-all activity. This is a pace that is hardly likely to make a dent in the unemployment rate; or to raise the rate of industrial capacity utilization sufficiently to touch off anything approaching a fixed capital investment boom; or to result in any strain on credit markets; or to stimulate or support any significant advance in industrial prices.

For the current quarter, GNP should be in the vicinity of $585 billion, annual rate; for the fourth quarter, $592-593 billion. If realized, these estimates would yield a total of $582 billion for year 1963, at the upper end of the Council of Economic Advisor's beginning of the year estimate of $578 billion ± $5 billion. The Council's estimate was predicated on substantial tax reduction, effective July 1.

This judgment about the near-term future is based on a variety of considerations, including the following:

1. Further expansion in Federal and State and local purchase of goods and services, with Federal outlays in the fourth quarter bolstered by an advance of $1 billion, annual rate, attributable to pay increases for the military.

2. Further advance in business spending for fixed capital, in line with the Commerce-SEC survey released in June. Broadly speaking, the findings of this survey have been supported by a fairly sustained rise in new orders for nonelectrical machinery.

3. The pattern of housing starts this year, based on the newly revised seasonal factors, suggests that the high in residential construction activity probably occurred in the spring or summer months. Some decline from these peak levels is likely.

4. Consumer spending should keep pace with incomes, with spending for nondurable goods making a better showing than the rather anemic one in the first half of the year. As you probably recall, retail sales changed little from late last year to May. Most recently, with incomes continuing to advance, retail sales in June and July broke out above the earlier plateau, with spending strong for nondurable goods.

5. On inventories, patterns in 4 of the past 5 years have been distorted by steel accumulation concentrated some time in the first half of the year and by liquidation concentrated in the second half. This year is no exception, but the pattern is unlikely to be as acute as in other recent years; accumulation has not been so large and the rate of steel consumption is higher. The moderate rise in new ordering for steel in July is consistent with this thesis. For inventories as a whole, accumulation is likely to be down in the

current quarter and to accelerate only moderately in the fourth quarter. With supplies and capacity ample, and with demands for goods showing only a modest further rise this year, incentives for large-scale accumulation are simply not present.

Longer Run Outlook

The record of the immediate past--including such foreshadowing measures as new orders and consumer and business surveys--is tenuous enough as a foundation for the near-term outlook; it is hardly any support at all for an appraisal of prospective developments over the next 16 months or so. For such an appraisal, broader considerations must weigh heavily in one's judgment.

It seems to me that national economic policy--fiscal and monetary--will be of crucial importance in shaping developments as we get into 1964. Fiscal and monetary policies may well be the decisive elements in whether or not we have recession next year; they will certainly be major elements in rates of expansion and degree of resource use for 1964 and beyond.

From fiscal policy, we need a combination of expenditure programs and tax reduction that would more than match the increase in potential full employment receipts. Expenditure programs alone, as presented in the Budget Message for fiscal 1964 and in the light of developments since then, would be insufficient. This gives the enactment of tax reduction legislation, of the general order of magnitude apparently being recommended by the House Ways and Means Committee, a high priority.

On monetary policy, assuming that the private economy will continue to generate a large and perhaps growing volume of gross savings, we need policies that at the least will not put upward pressure on long-term interest rates so long as unemployment remains high, industrial capacity more than ample, and inflationary pressures absent--whether from the demand or the cost side. Such policies are essential for maintenance of high levels of housing activity, for helping to encourage an increased volume of business spending on fixed capital, and for stimulating expansion in other credit using private areas.

Among the many potentially adverse consequences of a continued serious balance of payments problem is that monetary policy may be called on--and may actually attempt--to raise short-term interest rates again, this time sharply. The consequent effect on long rates, and more importantly, on the differential between long and short rates is certain to have a deleterious effect on domestic activity.

So far as the outlook is concerned the most ominous combination of public policies for next year would be a failure to enact substantial tax reduction coupled with an increasingly restrictive monetary policy.

I reach this judgment on the crucial nature of policy for next year because, without outside stimulus, prospective demands at best will permit but a modest, irregular pace of expansion that will not be sufficient to reduce the unemployment rate or to provide adequate stimulus for business spending on fixed capital.

We can reasonably expect Federal purchases of goods and services to continue to rise next year, but probably more slowly than this year; State and local spending to advance by $1 billion or so a quarter; and consumer purchases of services to increase by $2 billion or more a quarter. If disposable incomes rise, so will consumer spending for nondurable goods. So far, so good.

The critical uncertainties in private demand are: consumer purchases of durable goods and housing, business fixed investment, and inventory investment. Uncertainties exist also about the future course of exports and imports. One recurrent pattern of recent years that will be absent in 1964 is alternating influence on over-all activity of actual and prospective strikes in the steel industry. Taken altogether, these critical and sensitive areas might, at best, give us a slight plus; they could, however, also give a minus big enough to precipitate recession.

With reasonably favorable public policies uncertainties in these critical areas would tend to be resolved on the favorable side. Thus, with incomes bolstered by tax reduction and with activity and employment expanding, a total of 1.5 million housing starts in 1964 is probable, a figure not very different from what will be realized this year.

For automobiles, another 7 million plus year is reasonable in the light of continued growth in population, households, and incomes and the large and apparently rising volume of auto scrappage.

The course of business investment may well be the determining influence on over-all developments for next year. We can expect the internal flow of funds to continue in large volume, incentives to invest to cut costs to remain strong, and expenditures for replacements--now two-thirds of manufacturing investment-- to be substantial. Nevertheless, whether spending will rise slow or fast or whether it will decline, will be determined largely by incentives for enlargement of capacity in manufacturing, the primary incentive being the pressure of output on capacity. If recent utilization rates can be increased some, or even maintained, in the months immediately ahead and if favorable expectations for next year can be engendered, say - by tax reduction - manufacturers' plans for 1964 are likely to be on the expansive side, and total business spending for fixed capital might well continue to rise for some time. I need hardly remind you, however, that much weaker markets than assumed for housing, autos, and perhaps consumer nondurable goods could materially affect investment plans and spending for 1964.

If final demands turn out more or less as developed today, I would expect inventory investment to be an essentially neutral factor next year, with accumulation at a moderate rate.

Let me comment most briefly on prospects for our current account in the balance of payments, i.e., exports and imports of goods and services. The outlook for exports is not on balance unfavorable. I don't envisage over the next 16 months or so any marked departure from domestic industrial wage and price trends of recent years, which have tended to maintain the U.S. competitive position in world markets. Moreover, business conditions in Western Europe -- and perhaps elsewhere -- appear to be in an expansive phase. Let us not forget, however, that Western Europe and Japan remain highly competitive in important world markets.

But even if exports of goods and services are maintained, or are even increased moderately, would the next export balance be eroded by a surge in imports if domestic activity should move to higher levels? There are several reasons for discounting the likelihood of this.

First, imports in recent years have not grown as fast as GNP. Second, stocks of imported materials appear to be in closer balance with the level of domestic activity than perhaps any time in the postwar era, and there is no reason to expect any sudden disturbance of this balance as domestic activity moves to higher levels.

On the whole, then, a tentative prediction of "little change" may be the best guess one can make with regard to the direct impact of international transactions on the level of U.S. economic activity over the next year or so. There does not seem to be any reason for expecting sharp improvement in the current account of the balance of payments in the near-term.

Policy Issues

I turn now to the problems policy makers face and the effect of their decisions on the business outlook. The problems are the deficit in the balance of payments and a sluggish growth rate in the domestic economy with consequent unemployment. If I debate more than I discuss policies to deal with these problems, it is because that, in fact, is my posture. The fact that these issues are discussed later rather than sooner in my appraisal of the outlook does not mean, as I indicated earlier, either that public policies are of secondary importance or that they are passively adapted to developments in the private sector. We are, of course, dealing with an interdependent system in which public and private actions influence and react to each other. This reciprocal relationship has always existed at least implicitly between developments and policies. Now, for the U. S., there is an additional dimension to the link between public policies and economic developments; namely, the balance of payments and public policies to deal with it.

In today's world, the U. S. cannot neglect either the domestic or the international problem. The question is, what are the appropriate policies to deal with each of these problems. In view of the fact that the U. S. payments deficit is not of the traditional type, involving excess demand at home attracting excess resources from abroad, my view has been that we should not use traditional means to deal with it. Rather, general fiscal and monetary policies should be primarily aimed at domestic expansion while special purpose instruments are applied to the balance of payments problem. The recently proposed interest equalization tax is a step in this direction and, if needed, I would hope that additional measures can be developed.

I shall now discuss fiscal, monetary, and balance of payments policies in turn.

Fiscal policy.--There is little to add on the subject of fiscal policy beyond what I have said earlier. A tax cut is highly desirable as a contribution to aggregate demand, especially consumer demand. Without this contribution, the longer run outlook is much weaker.

I am not in a position to suggest the likely course of Federal expenditures in the period ahead, with or without the tax cut, but it is a reasonable assumption that they will continue to advance, though perhaps less rapidly than in the past two or three years. It is worth pointing out, however, that most evaluations of the impact of the tax cut on aggregate demand assume that this impact will not be counterbalanced by a slowdown in Federal outlays. From the fiscal policy point of view, Federal spending should continue to expand roughly in line with the growth of potential GNP.

Putting this in other terms, one may view the tax cut as a means of reducing the magnitude of the full employment budget surplus. The sizeable surplus that is implicit in the present budget acts as a drag on economic expansion, for it puts too large a burden on private investment to absorb the savings which our economy generates at high and rising income levels. If private investment is not buoyant enough to carry this burden, and it has not been, we succeed in achieving neither full employment nor the budget surplus. The implicit surplus can be reduced either by cutting tax rates or by increasing expenditures more rapidly than full employment tax revenues or some combination of the two. But it hardly makes a policy to use one tool for expansion and the other for contraction.

Monetary policy.--During the past couple of years, monetary policy has attempted to cope with conflicting objectives. It has sought to encourage full utilization of resources at home while also maintaining upward pressure on short-term interest rates so as to minimize incentives for capital to flow abroad.

Opinions differ on the degree of domestic stimulation from monetary policy in the past year or so. There are those who believe that monetary policy has been excessively easy and for too long a period, and has resulted both in a spillover of funds to other countries and in a deterioration in the quality of credit at home. Those who take this view support it by pointing to the large growth in commercial bank loans and investments at a time when credit demands were not intense. Last year, for example, commercial bank credit increased about 9 per cent as compared with a 5 per cent increase in GNP. From the trough of the recession in early 1961 to mid-1963, loans and investments at all commercial banks increased about 20 per cent, while GNP grew 16 per cent. On this evidence, it is claimed that the banking system was being provided with reserves to make a substantial contribution to the available credit supply.

It is necessary however, to analyze the credit growth in its full context. All of the monetary and credit magnitudes in the past year and a half have been significantly affected by the upward movement in interest rates paid on commercial bank time and savings deposits following changes in the Board's Regulation Q. An important result of these interest rate changes was that commercial banks became more attractive as financial intermediaries. A substantial fraction of the apparent growth in commerical bank credit simply represents a shift toward greater intermediation, as businesses and individuals were induced to increase their claims in the form of time and savings deposits at commercial banks as a substitute for direct holdings of securities or claims on other financial institutions. To the extent that this type of shift occurred, only a part of the increase in total bank deposits and bank assets should be regarded as constituting monetary expansion or as contribution to total credit expansion. The remainder represented a rechanneling of the financial flow of funds as the public added commercial bank time deposits rather than securities to its financial assets.

In further support of this interpretation of monetary and credit developments, I point to two significant facts. One is that the money supply, that is, demand deposits and currency, has increased at an annual rate of less than 2 per cent in the past year and a half. Secondly, the behavior of interest rates does not indicate that credit supplies have been excessive. Short-term rates have advanced and the decline in long-term rates has been moderate. Furthermore long-term rates remain high by historical standards. It is difficult to believe that long rates have declined by any more than is accounted for by the disappearance of the premium earlier demanded by lenders with inflationary expectations.

It is for these reasons that I would characterize monetary policy in the current upswing as having been passively responsive but not actively stimulative. Furthermore, I believe that were it not for the balance of payments constraint, monetary policy would have done much more to encourage economic expansion.

The policy of maintaining and in fact increasing short-term interest rates has acted as a direct impediment to further reductions in long-term rates which might encourage higher levels of domestic investment. As long as short yields remain high, lenders have little incentive to move out on the yield curve, for the cost of remaining liquid is very low. If we are to encourage capital formation, we need to make short-term assets less attractive to lenders so as to increase the availability and reduce the cost of long-term funds.

Monetary policy has in a sense had one hand tied behind its back. It has not really had a chance to exploit the elasticity that exists in the relationship between long-term interest rates and investment outlays. The problem is how can we give it a chance--that is, how can we permit a reduction in short- and long-term interest rates--without aggravating our balance of payments.

Balance of payments policies.--Our balance of payments problem may be characterized as follows: Although we have an export surplus in terms of goods and services, we are attempting to give and lend abroad an even larger amount. The result is that the rest of the world is acquiring short-term dollar claims on the U.S. at a greater rate than it appears to want them, while the U.S., in turn, acquires long-term claims on the rest of the world. In real terms, an export of capital which is not used to purchase American goods and services does not represent a real burden on the United States; it simply leads to a deterioration in our liquidity position. Ironically, the U.S. would be in less trouble internationally if the real burden of our capital exports could be increased.

Various policies have been adopted by the U.S. Government to attempt to deal with this imbalance as between our capital and current accounts. Among the major approaches, aid is being tied to U.S. exports, and a tax has been proposed on long-term capital outflows in the form of portfolio investment.

I believe these are steps in the right direction. Despite the criticism that has been levied at aid-tying by economists, it seems to me that this approach deserves encouragement and further extension. If it could be implemented administratively, a good case can be made for tying all capital exports and unilateral outflows to U.S. exports.

The United States, given its high real income and even higher potential income, is quite willing to provide real resources to the rest of the world in the form of an excess of export over imports of goods and services. We get into trouble internationally when we attempt to export dollar claims in an amount greater than our current account surplus.

If we tied capital flows to exports, an adjustment would come about in our balance of payments either through an increase in exports or a reduction in capital flows or a combination of the two. Such a measure would not, as I have said, restrict the ability of foreign nations to tap real resources here. It would simply restrict the export of unused claims on us. I should stress that by the term "tying" I do not necessarily mean a narrow concept of financing specific exports of capital goods. I would not want to rule out capital flows that contribute to the financing of domestic outlays abroad which in turn induce general imports into the recipient country from the U.S. But in cases where the recipient country does not need our resources, directly or indirectly, little purpose is served by a flow of capital.

It can also be argued that a policy of this general nature would be preferable from both the domestic and the international viewpoints, to a policy of direct discouragement of capital outflows because it would be less likely to discourage American exports.

For economists, the case against tying aid is based on the general belief that multilateralism makes for better resource use than bilateralism. With this general proposition, I am in full agreement. What economists need to examine, however, is whether the case of capital outflows (government or private) is also covered by this general proposition.

Finally, we need to remember that we are in the position of choosing among undesirable alternatives. Tying aid and capital flows may have disadvantages in terms of resource allocation. Before we reject this approach, however, we ought to compare its costs, both short and long-term, with the costs of alternative approaches to dealing with the balance of payments problem. In particular, failure to realize potential output and employment is a real and substantial cost.

It should be apparent that in my view the policy alternatives involved in achieving more rapid economic growth and reducing our balance of payments deficit are critical to the longer term business outlook. The traditionalist forecaster has, however, no clear crystal ball for predicting the moves of policy makers. For me it would not be appropriate at all.