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MOVING IN FOR A SOFT LANDING

Remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

in the

**George S. Eccles Lecture Series
Utah State University**

Logan, Utah

Thursday, February 9, 1978

SUMMARY

(1) The time has come to get ready for a soft landing, out of the orbit of rapid expansion to a stable base of long-term growth. A speed of 4-1/2 - 5 per cent GNP growth for 1978 is feasible, but we must get ready to decelerate, over the next two years or so, to a speed sustainable over the longer run. That will get us into a 5-6 per cent range of unemployment which is broadly the noninflationary rate of unemployment today.

(2) The barriers to expansion set up by limitations of manufacturing capacity will be reached before we approach those set by the availability of labor. In the short run, this will restrict our ability to reduce unemployment. Adequate policies to stimulate investment are needed to remedy this.

(3) Our large budget deficits at present fulfill the function of offsetting weaknesses in the economy, especially the trade deficit and the low level of business capital spending. But in the longer run, deficits weaken the forces of the private sector that must carry the economy forward. We must strengthen these forces so that the economy will again become self-sustaining at high employment.

(4) A soft landing will be hard to achieve unless we act more decisively against inflation than we have so far. To that end, I propose a tax on businesses granting excess wage increases. This tax would leave market forces unimpaired, but it would shift the balance of bargaining power in the direction of greater price stability.

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It is a pleasure to speak here in Logan in the George S. Eccles Lecture Series on a topic of importance to the outlook for our economy.

Within a few months, we shall be celebrating the third birthday of the economic recovery that got underway in April 1975. This recovery followed upon what was far and away the most severe recession of the postwar period. Measured by our distance from high employment and high capacity utilization, the expansion still has a considerable distance to go. But measured in terms of the duration of past business cycles, the present expansion has already gone a very considerable distance. Three years are about average for cyclical expansions in peace time. It is important, therefore, to take our bearings and see where we stand.

No expansion known to history has lasted forever, in our or any other Western country. That does not mean, however, that a much higher degree of stability cannot be attained than has prevailed in the past. Certainly we must make every effort to extend the present expansion, short of recourse to accelerated inflation which would only guarantee us a more painful recession a little farther down the road.

Extension of the present expansion requires that the rate of growth is gradually slowed down to a speed that would be sustainable into the future. At the present time, we still have an urgent need to absorb idle resources, human and material. The expansion, therefore, must proceed faster than the growth of the supply of these resources. But as idle resources are absorbed, the rate of expansion must adapt itself to their long-term growth and of the productivity with which they are being employed. Recovery must gradually phase into long-term growth. To accomplish this transition is the problem of a "soft landing."

In past expansions, we frequently have failed to make such a soft landing. The economy, on those occasions, continued to expand rapidly while approaching its limits of labor, plant, and materials capacity. Eventually it slammed into or even through these barriers, overheating in the process and accumulating all sorts of imbalances. A recession then became inevitable. If we want to avoid a repeat

performance, the economy needs to slow down as such barriers are approached. This is likely to take a considerable amount of time, certainly in excess of one year. On the other hand, the process of slowing down should not start too early. Otherwise it will take a very long time to absorb the resources that are still unused.

What we need to ask at the present time, therefore, are two questions: How fast is the economy currently moving, relative to past performances? How far are we away from the limits of utilization of human and material resources?

GNP in Past Expansions

Let us look at the five previous expansions that we have run through since World War II. The average ^{1/} annual rate of expansion from a trough of a recession to the subsequent peak in activity, in constant dollars, has amounted to 5.1 per cent per year, with a high of 7.3 in 1949 to 1953 and a low of 3.9 per cent in 1954 to 1957. The average cumulative expansion in GNP over this period has been 16 per cent with a high of 46 per cent in 1961 to 1969 and a low of 10.6 per cent in 1958 to 1961. During the four quarters preceding the end of each expansion, the rate averaged 2.7 per cent, with a high of 5.8 per cent in 1952 to 1953 and a low of 1.2 per cent in 1968 to 1969.

^{1/} The median is used throughout the paper to represent the average.

The most rapid rate of expansion achieved on each occasion during a period of four consecutive quarters averaged 7.7 per cent, with a high of 13.4 per cent in 1949 to 1950 and a low of 7 per cent in 1961 to 1962.

Comparable data can be estimated for the three years of the present expansion through the first quarter of 1978. The total rise, in constant dollars from 1975:I to 1978:I (estimated) will probably have amounted to about 18 per cent. The average rate of speed during those three years will have been 5.6 per cent. The highest rate during a four-quarter period is likely to have been 7.4 per cent. We, therefore, find that while the present expansion has proceeded on average a bit faster than those of the past, it has not been characterized by any abnormal bursts of speed. On a fourth quarter to fourth quarter basis, the last year implied a rate of 5-3/4 per cent.

It is sometimes argued that we could make better mileage by accelerating the economy vigorously as long as substantial amounts of unutilized resources remain which would then be absorbed more quickly. Then, when the end of the process seemed to be in sight, the economy could be slowed energetically in order to avoid hitting into the capacity ceiling.

This form of fine tuning, like many others, does not commend itself. We do not have enough control over the economy to achieve such precise effects. Moreover, once the economy had accelerated to a high

rate of speed, there would be widespread resistance to calling an end to the party. The braking effort required would be enormous, and the chances of a soft landing minimal.

By and large, there seems to be acceptance today of the need for moderation. During the four quarters of 1977 real expansion proceeded at a 5-3/4 per cent pace. While this rate was apparently 2 percentage points faster than the long-term growth rate, it seems to be widely regarded as a reasonably safe pace -- given the slack of unused human and physical resources. According to many forecasters, including the Council of Economic Advisers, expansion is projected to slow to the 5 per cent range over the next 12-18 months -- still a third greater than the long-run growth rate of 3-3/4 per cent. If realized, this somewhat more moderate pace of activity appears to be a prudent one in light of the further absorption of idle resources that occurred in 1977.

Labor Force Resources

We must now take a look at the availability of resources and the manner in which, during past expansions, they have been absorbed into economic activity. Unemployment, in five previous expansions, has declined on average by 2.2 percentage points. The average decline per year amounted to one-half of a percentage point. The largest drop in the unemployment rate was 4.4 percentage points in 1949 to 1952; the smallest was 1.1 percentage point in 1970 to 1973.

During the four quarters preceding the peak of the movement, the decline in unemployment averaged one-tenth of a percentage point. During the first year of recovery the unemployment rate fell an average of 1.4 percentage points. The level of unemployment attained averaged 4.1 per cent during the last four quarters of prior expansions.

We know, of course, that at cyclical peaks the economy almost invariably has generated serious inflationary pressures. The minimum unemployment levels attained, therefore, were not consistent with price stability. Moreover, the structure of the labor force has changed over time so that equivalent levels of unemployment in particular sectors of the labor force today lead to a higher average level of unemployment.

About the approximate level of "noninflationary unemployment," there exists today only a rather diffuse and by no means complete consensus which places this level somewhere in the 5-6 per cent unemployment range. In my own view, if we were to take appropriate structural measures to reduce unemployment where it is particularly high, and if we were to employ an incomes policy based upon the tax system such as proposed by various economists including myself, we could achieve substantially lower levels of unemployment without inflation. But in the absence of such measures the level of noninflationary unemployment is likely to be found to be

distressingly high. It will not be reduced by passing a law calling for three per cent adult and four per cent overall unemployment within five years after it is enacted. I know of no piece of economic research that lends support to the feasibility of that figure in the absence of an incomes policy of a sort that so far the nation has shown no willingness to adopt.

In evaluating these unemployment figures, it should be remembered that the proper measure of the performance of the economy in providing jobs and absorbing unemployed resources is given, not by changes in unemployment, but in employment. In recent years, the labor force has grown rapidly. This has resulted from the entry of large numbers of women and teenagers particularly. It is accepted that very high rates of expansion are likely to cause overheating and ultimately an overshooting of capacity barriers. There are commensurate limits to the ability of the economy to reduce unemployment within a given time span. So long as the growth of the labor force is high relative to the economy's rate of expansion, the reduction in unemployment will proceed with less rapidity than we would like to see.

The German economy during the 1950's provides an example of this process. Despite rapid increases in employment, the unemployed portion of the German labor force remained high because it was being fed by a steady stream of refugees from the East. Even the "German miracle" could not immediately cope with this inflow, and it took a

number of years before the entrance into the labor force could all be absorbed. But because German labor unions were seriously concerned about this unemployment and limited their wage demands accordingly, an eventual decline in German unemployment to about one per cent did take place.

Manufacturing Capacity

Capacity utilization in manufacturing is a second measure of the economy's ability to expand that we need to examine. In the five prior cyclical contractions in manufacturing capacity, utilization fell 9.2 percentage points and in 1974 to 1975 it fell 16.8 percentage points. In the first two years of the five prior expansions, this operating rate rose 8.9 percentage points and in 1975 to 1976 it rose 10.2 percentage points. By the third year of most expansion periods, capacity utilization had begun to level off or even to turn down. The highest rate attained was 91.5 per cent in 1966:I, a level facilitated by quasi-wartime conditions of production. Even so, inflationary pressures had become very noticeable at that point. Historically, such pressures seem to have set in at about the 88 per cent utilization level.

Today we are within 5 percentage points of that presumptive trigger point. It has been estimated that a reduction in unemployment to the 5 per cent level would carry capacity utilization to the level

of 91 per cent.^{2/} As of today, therefore, manufacturing capacity imposes a tighter limitation on future expansion than does the available labor force. Because we have underinvested for several years, our capital stock today is insufficient to provide employment to the labor force even up to what might otherwise be considered a noninflationary level.

Fortunately, manufacturing capacity can be adjusted reasonably expeditiously. The ceiling that it places on the economy's ability to expand is less enduring than that imposed by the dimensions of the labor force. Whether or not the necessary steps will be taken to increase capacity very much depends, of course, on the future course of events and policies affecting business capital spending. We now turn to that subject.

Business Fixed Investment

Over the post-World War II period, real capital stock in the nonresidential private sector has risen at about a 4 per cent rate per year. However, in the 1974 to 1977 period, the recession caused capital stock growth to slow to a 2.1 per cent average annual pace. As a result, by the end of 1977 our Nation's stock of plant

^{2/} William Nordhaus, "Will Bottlenecks Slow the Expansion" (mimeograph), presented at St. Louis Conference on Potential GNP, October 7, 1977.

and equipment had fallen 4.3 per cent below the level suggested by a simple postwar trend. Plainly, we are not investing enough to match our past performance, let alone make up for the recession-induced deficiencies in our capital stock. Two years ago, the Council of Economic Advisers suggested that business fixed investment would have to average 12 per cent of GNP in the later 1970's to meet full employment goals by 1980 as well as achieve specified energy and environmental objectives. While this capital spending requirement may be a bit on the high side, real business fixed investment accounted for only 9.9 per cent of real GNP in 1977:IV -- well below a desirable share of output given any reasonable consensus of policy objectives. In addition, the latest Commerce Department survey suggests this share will change little in 1978 as the anticipated rise in plant and equipment expenditures is expected to slow somewhat from last year's pace. In order to come close to the CEA's 12 per cent standard, business fixed investment would have to rise at a rate of about 30 per cent during one year or about 20 per cent for each of two years.

The present unsatisfactory level of investment spending reflects high perceived risk, high cost of capital, and low profits from existing capital as well as low expected profits from future investment. We have every reason to take steps to change these conditions and accelerate the rate of business fixed investment. Meanwhile, however, it is only realistic to accept that available manufacturing capacity places a limit on output that could

restrain the economy even more than limitations in the area of employment. Accordingly, the need to prepare for a soft landing could be closer at hand than the labor force data taken by themselves would suggest.

The Trade Deficit and the Budget Deficit

A soft landing requires also that all the components of our national income remain in some degree of balance with each other. Two components that are significantly out of balance today are foreign trade and the budget. In past expansions, the United States typically has had a slight surplus on foreign transactions -- positive net exports. At the present time, our national income accounts show that the foreign sector constitutes a net drag on the economy, in the form of negative net exports, equal to -\$10.8 billion. A strong effort is needed to redress this imbalance, especially through appropriate legislation tending to reduce oil imports and through more effective control of inflation. Much will depend also, however, upon the ability of foreign countries to expand their economies and to catch up with the United States. At present, we are significantly ahead in our cyclical recovery of most other countries.

The deficit in our net exports leaves a demand deficiency of about \$25 billion or 1.25 per cent of GNP. In earlier expansions the economy was typically able to count on net exports for a contribution

to aggregate demand of about \$3 billion -- during this recovery, net exports have deteriorated nearly \$22 billion. Under present conditions the economy must look to some substitute source of demand if the contractive effect of this deficiency on total demand and GNP is to be made up. In evaluating this quantity, it needs to be remembered that business fixed investment, running at 9.5 per cent instead of 10.5 per cent of GNP, also leaves a demand deficiency of about \$20 billion, and that State and local authorities show a surplus of about \$13 billion (excluding pension funds), making a total deficiency from trade and investment of about \$58 billion or 2.9 per cent of GNP.

The Federal deficit, which including off-budget items was \$54 billion in fiscal year 1977, is expected to rise to over \$73 billion in fiscal years 1978 and 1979 or 3.0 per cent of GNP, provides an offset, and more than an offset, to these deficiencies in aggregate demand. Government expenditures, in addition to outright Federal purchases, help finance private consumption through massive income transfers, State and local expenditures through grant programs, and, on a very minor scale, business expenditures if we consider the investment tax credit as a form of tax expenditure.

Thus, for 1978 the budget deficit serves in large part the function of filling gaps in the economy and of filling gaps in the structure of aggregate demand. For 1979, however, the demand deficiencies that need to be offset should be smaller, which raises a question about the appropriate size of the fiscal 1979 Federal deficit. But even more important than that, there is a fundamental aspect to these deficits that raises very serious questions about the future of our economy.

Our practice of heavy deficit spending -- only four surpluses in the last 25 fiscal years, and these miniscule -- is in part responsible for the inadequate working of our economy in the areas of international trade and investment. Deficit spending has contributed to inflation and has undermined our international competitiveness, to the point of forcing a devaluation of the dollar. Deficit spending and the attending inflation have likewise undermined investment incentives. The steady encroachment of government, through deficits, regulation, and adverse tax policies, has contributed to the hesitancy we now observe in the business investment sector. Government has advanced, and the private sector has retreated. The weakness of the private sector then has become a reason, or at least an excuse, for further expansion of government.

In a healthy economy, there should be no need for the artificial stimulus of a budget deficit. The demands of the private sector, for consumption, housing, and business investment, together with foreign trade and a normal level of public sector activity, should be adequate to generate full employment. Indeed, it has generally been thought that at full employment private demands should be strong enough to allow government to run a surplus. In studies of our future investment needs, a degree of government debt repayment has often been featured as a necessary component in the equation matching the supply of saving to the Nation's investment needs in an age of energy shortage, environmental protection, and enhanced health and safety standards.

Now, however, we are being told by the Congressional Budget Office that the expansion strength of the private sector is not sufficient to push the economy back to a high level of employment by 1983. Continuing support from a budget deficit is said to be needed in order to move the economy there and keep it at that level. If true, this would be grim testimony about the diminishing health and vigor of our economy.

Inflation

I am skeptical of projections like these, because I have faith in the recuperative powers of the economy. I see great needs for investment, and I believe that the private sector, given a chance, can meet these needs. One essential condition, however, will have to be met: We must come to grips with inflation.

I have discussed the possibilities of moving to a soft landing as the economy reaches high levels of utilization of human and material resources without reference to price movements. We need to face up to the question, however, whether any kind of stability can long be sustained at a high level of inflation. There are those who believe that we can "live with inflation" and adjust to something like the present level. That, I am sure, is an illusion. The present level of inflation creates serious distortions, affects investment, saving, foreign trade, and ultimately all other activities in the

economy. Moreover, if we are not prepared to hold inflation at close to zero, there is no reason to think that we would be prepared to do what it takes to keep it from accelerating above its present 6-7 per cent. We cannot, therefore, hope to reach stability at a high level of operation unless we are at least making demonstrable progress in winding down inflation.

In this struggle against inflation, we shall have to use all available options. Fiscal policy, operating through the budget, will have to become more restraining as the economy reaches high levels of operation. Monetary policy will have to wind down the rate of growth of the money supply as quickly as consistent with continuation of the economic expansion. The government will have to go to work to undo the many price-raising effects of which it is itself guilty.

Moreover, an incomes policy consistent with free markets will have to be employed, in my opinion. I have described what I believe to be a workable policy, developed by others as well as myself, on various occasions. Its principle consists in using the tax system to strengthen resistance to excessive wage increases. There would be no controls. Markets would continue to function in setting wages and prices as before. But businesses granting excessive wage increases would find their tax bill upped. The balance of bargaining power

would shift in the direction of great stability. I believe that this policy, energetically implemented, would break the back of the stubborn inflation we are now suffering. It would pave the way for a soft landing, and it would make possible a permanently lower level of unemployment without inflation.

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