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AFTER THE PEAK ?

Remarks by

Henry C. Wallich

Member, Board of Governors of the Federal Reserve System

to the

New York Society of Security Analysts

New York City

Monday, August 27, 1979

SUMMARY

(1) The absence of major imbalances in the economy gives us grounds for expecting a shallow recession, although the recovery may be slow.

(2) Falling real consumption is the main cause of recession, resulting from inflation that is outrunning incomes.

(3) Moderate wage behavior so far is an element of strength that should permit a reduction in inflation without loss of income share for labor.

(4) The strength that has been exhibited by the dollar is another positive factor against inflation.

(5) Inflation remains our main problem, because today inflation is also the cause of unemployment.

(6) Inflation must be fought not only by fiscal and monetary policy, but with the use of incomes policy and by ending the many price-raising activities of the Federal Government.

(7) Fiscal and monetary policy must remain on a steady course, rather than switching back and forth between fighting inflation and fighting unemployment.

(8) It is too early for a tax cut, although fiscal drag will force a cut eventually.

(9) Monetary policy should aim, over longer periods, at maintaining positive real interest rates.

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It is a pleasure to speak to this meeting of the New York Society of Security Analysts about the state of the economy. I am grateful to have this opportunity of addressing members of a profession to which I belonged a good many years ago and left to pursue the safer calling of an economist.

The Federal Reserve Board's view of the economic outlook was presented to Congress six weeks ago in compliance with the Humphrey-Hawkins Act. The projections formulated in terms of ranges, for 1979 and 1980 respectively, included a growth rate of real GNP of -2 to -.5 percent and -.5 to 2 percent, inflation of 9.5 to 11 percent and 8.5 to 10.5 percent, nominal GNP of 8 to 10 percent and 8.5 to 11.5 percent, and fourth-quarter unemployment in the ranges of 6.25 to 7 percent and 6.75 to 8.25 percent. These projections were in some respects less optimistic than those presented by the administration in July. An important difference was in the somewhat slower speed of the recovery anticipated in 1980.

Personally, I have some philosophical difficulties with the making of a group forecast, such as that of the members of the Federal Reserve Board. Neither a compromise among different views nor a majority vote seems to be the right answer. If, under conceivable circumstances, some members of a group should believe that the economy was slowing and others that it was accelerating, to compromise on stable growth would not be a good solution. And while one can always be outvoted, one cannot be made to think what one does not believe. In regard to the above projections, however, I feel comfortable, except that I fear that they may not give enough expression to the risk of accelerating inflation. Forecasters have almost universally underestimated future inflation, and one should make allowance for that.

The recession anticipated by the Fed's forecast is not of the V-shaped variety as that of 1974-75, but of the saucer type, like most postwar recessions. I would like to say a few words about the general appropriateness of anticipating a recession at this time, somewhat independent of the specifics of the situation. If the expansion which began in the spring of 1975 peaked out in the first quarter of 1979, which remains to be seen, it would have lasted approximately four years. This would make it the longest peacetime expansion since World War II, well in excess of the average duration of cyclical expansions in peacetime, which has been of the order of 2-3 years. Our economy has been cyclical for as long as we have reliable records. We have learned that our ability to curb the business cycle is far more limited than what Keynesian economic theory, until quite recently at any rate, has

sought to make us believe. In view of all this, it does not seem to be unreasonable to say that the expansion had probably run its course and that a slowdown was "due."

The view that our economy is cyclical must contend, to be sure, with the historical fact that recessions do not fall into a single pattern. Inventory fluctuations, induced by speculative accumulation as the economy approaches capacity, have been the most frequent ingredient. Fixed investment booms and recessions have also been a characteristic feature of many but not all cycles. Given the lags built into the productive process, periods of 2-3 years seem to be sufficient to allow substantial imbalances in either inventory or fixed investment or both to occur that need to be worked off. But it is quite possible for an expansion to proceed with sufficient moderation so that neither of these imbalances arises. The expansion then could go on without interruption as long as growth stays within potential.

The recent expansion has been characterized by an absence, broadly speaking, of the familiar inventory and investment excesses. It is significant, therefore, that contractive tendencies nevertheless are making themselves felt. This time it is consumption that is principally responsible for the slowdown. Weak consumption is in part the result of exogenous factors, such as the rise in energy prices. But endogenous factors, too, are weighing upon consumption, such as the mounting volume of consumer debt, the low saving rate, and very particularly the decline in consumer purchasing power resulting from earlier price increases. We must remember that the acceleration of inflation which cut into income and consumption began well before the rise in energy prices.

It goes back to 1978, when capacity limits were being approached. A demand pull type of price rise originated then that was intensified by food and weather before impulses from the energy side took over. Thus, by a different mechanism which did not involve inventory or investment excesses, the cyclical character of the economy has once more asserted itself.

I believe that these cyclical characteristics of our economy need to be more clearly understood and better kept in mind if we want to avoid repeating the policy mistakes of the past. If we treat every recession as a unique event, surprising and explainable only by the failure to adopt simple and obvious remedies, we misread the facts. If we conclude that recessions are simply mistakes, due to nothing but the incompetence of economists or the ineptitude of policymakers, we are likely to take the wrong turn. We shall be driven to repeat the familiar sequence of policy switches since 1961, from fighting unemployment to fighting inflation and back to fighting unemployment, with each temporary objective inadequately attained while the temporarily neglected evil was gathering strength. In this way we have ratcheted ourselves up to very high rates of inflation and at times high rates of unemployment. A policy of less fine tuning and greater steadiness, keeping in mind both inflation and unemployment at all times, seems better suited to the short-run cyclical character of our economy.

Next, I would like to examine some particular features of our present situation. I shall begin with the very high rate of inflation, which implies a half-life for the dollar of something like 5-7 years unless

materially brought down. As I noted earlier, this inflation has had both endogenous and exogenous origins, and at different times has reflected both demand pull and cost push. The demand pull phase began late in 1978. By historical precedent, capacity utilization was still somewhat below the levels at which capacity pressures and supply limitations had tended to make themselves felt. In the past, these pressures have been felt at percentages in the high 80's for manufacturing and at about 90 percent for materials. On this occasion, pressure seems to have been felt in the middle 80's for manufacturing and high 80's for materials. Among the reasons for this seem to be obsolescence of some productive facilities owing to the rise in energy prices since 1973, and perhaps also to environmental restrictions, as well possibly as defects in our methods of measuring capacity.

That oncoming shortage of capacity could be seen a long time ahead, beginning in 1975. Investment during the expansion that began in 1975 was low almost throughout its course. Business fixed investment averaged about 9.6 percent of GNP while numerous estimates suggested that continued growth at historic rates would require it to be of the order of 11 or 12. When, during 1977, unemployment declined dramatically without a commensurate increase in output or of capacity utilization while fixed investment accelerated, earlier concern about an impending capital shortage was temporarily muted. But the additional employment was mainly outside the manufacturing sector, and economic growth was associated with very low productivity gains. As it turned out, we were indeed reaching capacity limits both of labor and capital.

Policy moved too late to slow the economy down for a soft landing. In the last quarter of 1978, a final surge of activity and an acceleration of inflation made clear where the productive limits of the economy were situated.

Early in 1979, inflation received further impulses from food and weather, as already noted, combined with very poor productivity experience. Mounting energy costs took over thereafter and are still at work raising the producer and the consumer price indexes.

The only favorable development in this picture has been the moderate behavior of wages. Given the decline in real wages since early 1978, which has played an important role in the decline in consumption, it would not be surprising to see a strong effort on the part of wage earners to regain lost ground. But since that ground is lost not only to labor but to the entire economy as the OPEC "tax" and shrinking productivity eat away at domestically disposable income, an effort to maintain or increase standards of living would be doomed to failure. It could only contribute to further inflation. That this has not happened so far is one of the few elements of strength in our situation. That it may happen in the near future is one of our greatest dangers.

A similar risk existed in 1974, when the rate of inflation reached 12 percent. Wages accelerated very moderately following this development, as indicated by the 1975 rise of 7 percent in hourly earnings and of 8.5 in compensation per hour. The risk that these increases might go into wages was avoided. In part this was probably due to the fairly tight policies

maintained, at the cost of a substantial rise in unemployment. In 1976, inflation accordingly was cut by more than half, to a rate of 4.8 percent.

The evidence of the 1974-76 episode seems to show that inflation is capable of being reduced. Our aim during this new round of double-digit inflation must be to make possible a similar reduction by preventing the inflation from spilling over into wages, without a commensurate cost in unemployment. Once inflation does enter into wages, the wage-price spiral tends to prevent reduction in inflation, as the experience of the last 50 years makes clear.

Labor income in the aggregate did not suffer damage from the 1974-75 wage restraint, relative to the share of other income recipients. Labor's share in GNP was 61 percent in 1973, 62 percent in 1974, and 61 percent in 1975. Undoubtedly there were shifts within labor income between strong and weak bargainers.

An important ingredient in the present inflation outlook is the position of the dollar on foreign exchange markets. The impact of exchange rate depreciation on the domestic price level has turned out much larger than many observers expected. The need to maintain a strong dollar is enhanced accordingly.

Of the three principal factors that affect the exchange value of the dollar -- the current account balance, inflation, and interest rates -- only the first is clearly moving in favor of the dollar. Fortunately, it has also revealed itself as the most powerful, at least in the short run. Activity in the United States is decelerating while abroad it is still going

at a good, although oil-diminished rate. Our current account, by the end of the year, should be again moving toward surplus. It can be expected to go into surplus in 1980. Historically, the income effect, reflecting GNP movements, has always proved much stronger than the price effect, reflecting the real exchange rate, in shaping the current balance. That should be decisive in the present situation, even if a stronger dollar, a higher rate of inflation, and worsened productivity exert some influence in slowing down the improvement. It has often been observed that relative price levels, as influenced by inflation differentials among countries, become significant only in the longer run and with considerable delays. It is worth remembering also, in this context, that the effective exchange rate of the dollar has depreciated, since March 1973, by about 17 percent in real terms and that its appreciation, since October 1978, again in real terms, has only amounted to about 3 percent.

Interest rate relationships have deteriorated for the dollar since the most favorable differential was reached in late 1978. At the present time, the differential between U.S. short-term rates and a weighted average of foreign short-term rates has been more than halved. It has been observed that as inflation began to accelerate in 1979 all over the world, most other countries raised their interest rates quite substantially while the United States raised discount and Federal funds rates more moderately. But it must also be noted that interest rate increases in other countries occurred in the context of expanding economies while the United States economy has been slowing down.

During the period in 1978 when interest rate differentials were moving in favor of the dollar, the beneficial results were disappointingly slow to materialize. Perhaps this has reflected a tendency of real interest rate differentials to move less favorably than nominal differentials. More to the point, however, seems to be that gains from investment at more favorable interest rates accrue only very slowly. Gains -- or losses -- from exchange rate movements can materialize very quickly. Where exchange rates are strongly influenced by other factors, therefore, the influence of interest-rate differentials appears to be secondary.

After this review of domestic and foreign factors, it seems appropriate to turn to policy. I need not repeat in detail what has been said so often, that it will be difficult to defeat this inflation with only the traditional weapons of fiscal and monetary policy. Incomes policy, whether tax-oriented, as I would prefer, or otherwise, must continue to make a contribution. I believe that the wage and price guidelines, shaky though they are, have done some good in this respect. A large contribution can and must come also from a reorientation of the government's many policies that contribute to inflation, including environmental and health and safety regulation, minimum wage policy, Davis-Bacon standards, farm price supports, trade restrictions, and many others, together with vigorous antitrust policy.

As for fiscal and monetary policy, I have already said that steadiness rather than fine tuning must be the watchword. Fiscal policy has been moving in a tightening direction, because inflation is pushing taxpayers into higher brackets. The full employment deficit prevailing until 1978 has shifted into surplus, even though calling it a surplus rests on an unrealistic

assumption as to what constitutes full employment. It is clear that at some point, if inflation does not abate, a tax cut will be needed to avoid excessive fiscal drag. But that time is not close at hand, as the actual budget figures show. The economy's present position at probably more than full employment, in terms that today unfortunately are realistic, still yields a very large deficit. If we include off-budget expenditures, as we should, the deficit for fiscal 1979 is likely to be about \$40 billion.

Monetary policy meanwhile, if anything, has eased in real terms. With the consumer price index increasing at an annual rate of over 13 percent during the first half of 1979, short-term interest rates have been clearly negative in real terms, and substantially negative after taxes. The long-term real rate is harder to assess. One reassuring factor is that the upward movement of bond yields indicative of rising inflation expectations has been moderate. The present evolution of long-term rates, however, must be viewed in the context of a declining economy and a diminishing near-term volume of long-term debt issues.

Over longer periods, I believe that it is essential to maintain positive real rates, at least before taxes. Negative real rates are inflationary and are likely also to lead to misallocation of resources, as unworthy investment projects become easily financeable. But it is clear also that interest rates cannot follow every surge of inflation. The present condition of negative short-term real rates is a result of such a surge. A policy aiming at positive real rates over the longer run must operate with great circumspection in the short run and take into account not only interest rates, but

also the behavior of the monetary aggregates, bank credit, and fundamentally, of course, the behavior of the real economy.

In terms of the monetary aggregates, too, the stance of monetary policy may have been more expansionary than appears. That M-1 numbers in recent months must be raised by about one percent in order to compensate for the shift to ATS and NOW accounts is well known. It makes the very high growth rates that began in April, with few interruptions, averaging almost 11 percent for four months, the equivalent of around 12 percent. But simultaneously there has been a rapid run up of a variety of quasi-monies, including RPs (repurchase agreements), money market mutual funds, Eurodollars held by U.S. resident and nonresident nonbanks, all of which have substantially added to liquidity. One may feel unsure whether they belong with transaction balances (M-1) or with the time deposits that are one of the ingredients of M-4. Their availability for making payments is less than that of transaction balances but probably on average much greater than that of most time deposits which have a minimum maturity of 30 days. If these quasi-monies were included in M-1, their fast expansion would raise the growth of that aggregate very materially, perhaps to the extent of doubling it for recent months if timely data were available. Included in the much larger total of M-4, the impact of these quasi-monies would still be substantial.

In surveying the evolving situation, it is clear that two competing considerations must be kept in proper balance. They are the dominant role of inflation in our economy, and the nature of the risks that exist at the present cyclical juncture. Inflation has not only been our major problem on the way up, but we now observe it also driving the downturn. It does so

by depriving the consumer of part of his real income. It also contributes to weakness of business spending through the uncertainties that it creates both for the short- and long-term outlook and for the profitability of any particular investment. Inflation undoubtedly has had to do with the decline in productivity over recent years, although that phenomenon certainly has numerous roots. The malign influence of inflation therefore has been pervasive both on the upside and the downside of the business cycle. This argues for concentration of all our efforts in combating it.

At the same time, a review of our cyclical situation suggests that as far as output and employment are concerned, most of the risks are on the downside. While serious imbalances in inventories, business fixed investment and housing are not discernible at this time, they could develop as a result of the slowdown. Unpredictable developments relating to energy, strikes, and events abroad could change the course of the economy, and more likely for the worse than for the better. The possibility that the cyclical evolution may be milder than anticipated cannot be ruled out either, but the chances seem distinctly smaller. These considerations should inject an element of caution into economic policy.

In conclusion, the case is strong for a steady policy, avoiding overreaction and quick shifts from one objective to another. A policy of steadiness, as it gains credibility, will also help the market make better decisions. If we can adhere to a policy of steadiness, in reducing inflation and lending strength to the dollar while being aware of cyclical developments, I believe we will best be dealing with both our short- and long-run problems.