

ARE SIMPLISTIC SOLUTIONS THE ANSWER?

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by

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*I've grown accustomed to his face -
My Fair Lady*

Discussing the economy with this audience is ^{*at the same time*} ~~always~~ a privilege and responsibility. Speaking to you last year, I noted, at some length, why we were optimistic about the short-run but alluded only briefly to my concern about longer-run problems. I plan to continue with this theme today, after reflecting on 1976.

1976, as a whole, was a fairly good year, using the words "as a whole" deliberately. We had a good spring, and then the recovery paused--at least during the summer and early autumn. Retail spending leveled off for about six months. Industrial production declined briefly. Federal spending fell short of budgetary expectations, ~~and~~ ^{and} capital investment expanded less and more slowly than anticipated.

To spur the economy, the new Administration has now proposed a two-year \$30-billion plan which the Congress is already debating. Personally, I don't feel a considerable amount of fiscal stimulus is really necessary, though my mind on this subject remains open. But on one point, I am certain: Too much public discussion has centered on simplistic, temporary solutions, and not enough on the long-term structural economic problems. Let me tell you why we feel this way.

But, first, a word on whether the economy needs a strong shot in the arm. Will it slip into recession unless fiscal stimulus is applied? We don't think so; we are confident about the short-term outlook and for several reasons. First, our economic fabric lacks many of the excesses of the past. Overborrowing and overlending are not present on any major scale today. Exuberance and speculation have been

replaced by conservatism and caution. So the telltale signs of a new cycle of boom and bust are lacking. A second reason for optimism is that inflation--so heavily responsible for the last recession--slowed in 1976. Third, the Federal Reserve has kept credit readily available. And partly because of reduced inflation, interest rates are at their lowest point in four years. ^{Finally} ~~Fourthly~~, recent signs suggest that the economic pause, or lull, has ended. Production has rebounded. Retail buying has strengthened. Home-building in many areas has picked up, and government spending evidently has gotten back on track. So, according to many indicators, the economic tempo now beats faster than it did a few months ago.

But how fast? The economy's current pace is still unimpressive. In terms of real growth, it is certainly much lower than the 6-percent rate which the business-oriented Committee of Economic Development has recommended as this nation's goal. President Carter has also set 6 percent as his goal for 1977.

What about unemployment and the prospects for solving that problem? Here, we believe a quick reduction in the nation's unemployment rate seems unlikely. Whereas unemployment typically falls sharply after recessions, the unemployment rate in the current business recovery has been very sticky. For this, insufficient economic thrust and rapid labor force growth share much of the blame. The economy has not grown fast enough to absorb the influx of nearly 3 million persons during this past year alone.

What does this suggest for the future? It means that the unemployment rate may not decline even if real economic growth rises to 6 percent or better unless fewer people, particularly women, seek work. With the prevalence of more and more two-job families, higher unemployment than we are accustomed to seems inevitable, at least for a while.

Does the recent outpouring of other favorable news mean the economy is headed for a dramatic surge? We doubt it. True, corporations have stepped up their equipment buying; but they have been reluctant to move ahead with major construction projects. In recent quarters, every time the Commerce Department reported the amount corporations actually spent on plant and equipment, it was less than what they had previously said they intended. That's a bad omen. And if industry does follow the plans reported in the latest surveys, total business capital spending, adjusted for inflation, will increase only modestly in 1977.

Other construction areas also remain sluggish, especially the commercial and public sectors, though this does not completely apply to Atlanta. State and local government spending, meanwhile, remains under budgetary restraints. And high taxes together with persistent although reduced inflation continue to hold down increases in real consumer income, or buying power.

U. S. exports, too, have fallen short of previous hopes. There is no way to have rapid export growth unless the rest of the industrial

world enjoys vigorous economic expansion. Major foreign countries have actually experienced slower economic recovery than we have; and this trend seems unlikely to change dramatically. The Organization for Economic Cooperation and Development predicts this year's expansion for its industrial nation members will be even more modest than last year's. If this happens, foreign demand for U. S. exports will probably contribute little, if anything, to our own business recovery.

On the brighter side, two of our biggest industries--autos and homebuilding--either moved up during late 1976 or ended the year on an improving note. And in each case, there seems room for further modest gains. Consumers have been receptive to all but the small model cars, and they are finding mortgage money more available and mortgage rates coming down. Yet, the already high level of housing starts, auto sales, and current price tags argue against overoptimism about both sectors. So, it appears that business activity might not grow vigorously this year. On the contrary, we'd be most surprised if the average growth rate for 1977 hits 6 percent.

What about fiscal stimulus? Will a reasonable amount of fiscal stimulation give the economy a large head of steam? Probably not, unless it has that effect in the very near future.

The amount of thrust fiscal stimulation can provide will depend, of course, on the shape of the final legislation. Past experience ^{suggests} tells ~~us~~ that a one-time tax rebate or temporary tax cut stimulates consumer spending more quickly than do permanent reductions in tax rates. But

we have also seen that consumers save much of their tax rebates and that their stimulative effect on the economy starts to diminish fairly quickly. Permanent reductions in tax rates, on the other hand, apparently have a longer-lasting effect on the economy than do rebates.

The impact of any tax reduction proposal also depends on how it is divided between individuals and businesses. Tax relief for business, for example, would help corporations reduce their borrowings. This would tend to push interest rates lower or keep them from going up. That might be one way to help speed up the economic tempo and, simultaneously, minimize friction in financial markets.

An expenditure approach for job-creation purposes has other consequences, deserving a much more rigorous scrutiny than one can give here. The media have reported many different spending proposals, ranging from small increases for public service programs to bold energy development and mass transit schemes. I think we would do well to guard against spending programs that might create future inflationary difficulties. If any major expenditure programs are enacted, they should be so designed that they can be readily phased out.

Finding a fiscal program that attacks lagging growth in the short-run and is still compatible with our longer-range goals of reducing inflation and unemployment is no easy task. Even without fiscal stimulus, the budget deficit for the current fiscal year already amounts to \$60 billion. New fiscal stimulation will add to the deficit. A larger deficit, in turn, forces the government to borrow more money, which could lead to

interest rates that are higher than otherwise and, perhaps, to higher inflation.

Nevertheless, I believe that a modest, well-designed tax cut would be a wise move, for one basic reason: We need it to preserve confidence. (add)

all guys are aware of
After all, confidence is extremely crucial to economic health. ~~There are many~~ past examples where uncertainties about government policies inhibited spending and investment decisions and curtailed future plans of businessmen and consumers alike. Today, we need ^{badly} ~~additional~~ consumer confidence and spending if we want to encourage businessmen to build new facilities in anticipation of future sales. We also need greater business confidence. Quite clearly, more money spent on productive capacity, in turn, helps generate new jobs.

Promised a tax cut, the public seems convinced that taxes will eventually be reduced. Consequently, unless taxes are reduced, we may risk a loss of confidence and, therefore, face another lull in economic activity. The sooner a modest tax plan is put into effect, the better for the economy. Let the economic patient take his aspirin and be done with it.

But in considering what brand of aspirin is best for the economy or devising exactly what kind of fiscal package would be appropriate, let us not overlook this vital consideration: Fiscal tools used to attack economic ills of the '40s and '50s may not work equally well in the '70s. The economic environment during the past few decades has

significantly changed. I think we should not ignore these changes. In fact, this different economic climate suggests that these traditional policies and programs may no longer fit.

What is so different or new about today's economy? First, cheap and abundant energy is a thing of the past. We used to ignore its cost and availability; today we can do neither. The OPEC cartel, recent disagreements notwithstanding, dictates to the world the price of crude oil and, indeed, its availability. Though this nation still produces 60 percent of its oil domestically, it, too, has come under OPEC's spell. Therefore, quite appropriately, we now pay more and more attention to energy conservation and the development of new energy sources.

A second distinction of our present economic setting is that our productive capacity is less adequate for the long pull than it was in earlier decades. We have been warned that this nation is investing too little of its GNP on new productive capacity. Also, much current capital spending goes to reduce pollution rather than to increase capacity. We all know that it takes a long time to start a new paper or chemical facility. Shortages of basic materials can develop, therefore, faster than we might realize. In the same vein, medical and health care, though they have expanded, still do not meet current demand, much less future needs.

Third, our economic structure and labor force have both changed. Our economy is becoming increasingly more service-oriented. Women and

young people are looking for work at an ever-rising rate. A college diploma no longer is the passport to a good job and instant success, and the government is employing a larger segment of the population.

No listing of major economic changes would be complete without our mentioning inflation. In the '50s and '60s, annual price increases of 3 percent or more were unusual. Last year, we had a 5 1/2-percent rise--actually a big improvement over the double-digit 1974 experience but still too high. Helping in 1976 was an increase in productivity, a scaling down in wage increases, and a reduction in food prices. I might add that chances of a significant easing in price increases in 1977 are unlikely. On the contrary, recent livestock prices have already stopped to decline and industrial commodity prices have accelerated. It is no wonder that many analysts expect the inflation rate in 1977 to rise.

There is an interesting parallel with conditions in other countries. Most nations have been plagued with many of the same problems that we have encountered. Insufficient material, energy, and industrial resources, on the one hand, and too much labor resources, on the other, have created difficulties of coping with inflation, unemployment, and growth for them, just as they have for us. And the world's economies have moved together, partly because of floating exchange rates and the rise of multinational corporations.

How then should the Federal government in its longer-term policies and programs react to these changes in the economic environment? I think

we would be well advised to rely on measures pinpointed to the particular problems to be corrected. This doesn't mean general monetary and fiscal measures have no role to play; they are appropriate for economic stabilization. But they don't correct fundamental ills or specific problems. They are, in fact, as we have seen these past ten years, capable of making problems worse than they already are, particularly in the economic environment of the Seventies. For example, monetary and fiscal stimulation have the effect of increasing the demand for goods and services. That's well and good when resources are plentiful and prices are falling. But the amount of new machinery and facilities put in place has been subnormal for years, although at the moment most industries have capacity to spare. So, in today's setting it is important that the amount of fiscal stimulus eventually provided is no greater than the amount businessmen expect. To do anything else might raise the spectre of accelerating inflation, causing businessmen to delay their investment plans. We should not let this happen.

Let us also be aware of the possibility that private demand pressures could be greater than we now expect. Combined with too much fiscal stimulus, they might create excess demand. Similarly, inflationary supply pressures may confront us more quickly than we now perceive. These pressures can develop from many different sources: Shortages of skilled labor, limits on general industrial capacity, or shortages of particular commodities or sectors, such as health care or energy.

Should consumer spending speed up too quickly and investment in new facilities continue to lag, shortages and bottlenecks will develop sooner rather than later.

There is the added possibility that inflation will accelerate. This could result from corporate pricing policies, such government actions as higher minimum wages, or faster wage increases.

Therefore, in developing a short-term strategy of stimulation, we should exercise caution. And in developing a longer-term strategy for attacking special problems, we should pinpoint our targets. It's far better, for structural problems, to use a scalpel than a sledgehammer.

Let us give special emphasis to correcting supply and capacity problems. For example, as part of an energy policy, we should consider taxes on use, or credits for nonuse, to get businesses and residential consumers to conserve energy. We should consider tax credits for encouraging new technology and the use of new energy systems. We should refine our present tools, or develop new ones, for reducing unemployment in the inner cities, especially among black teenagers. In this connection, tax incentives for business and a lower minimum wage for youths than for adults deserve a close look. We should certainly correct programs that discourage persons from doing productive work. And we should sharpen our fiscal tools as well as reexamine our tax system in order to stimulate capital investment. Specific government programs to deal with sectoral problems would seem far more effective than general monetary and fiscal policies.

Simplistic solutions for attacking deep-rooted difficulties won't work, if they ever did. There is no magic wand for correcting structural problems. But we ought to work harder about finding better answers, especially in the area of resources. I am of the firm opinion that the long-run solution to coping with inflation lies as much in increasing supply as in checking excessive demand. Past policies have not paid enough attention to supply and capacity problems. We will be running a great risk if we do not change our present emphasis.