OUR "NEW ERA" IN ECONOMIC POLICY

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I am pleased to have this opportunity to talk with you today. There have been few times when economic developments have been more exciting than they are right now. And probably even fewer times when there seems to be so many opportunities to get our economy straightened out--or--to botch up the job.

That we appear to have crossed over to a new era of economic policy is of interest and concern to all of us. But I hope that the concern does not show itself only in terms of curiosity or in a passive review of what is being done to us or for us. I would hope that each individual and group in our society seizes the opportunity--in fact, the responsibility--to assist in the formulation of programs and policies necessary for a strengthening of our price market-oriented economy.

I must emphasize this strengthening at the outset. I have been concerned about an all too prevalent attitude that prices no longer have an important role to play in our economy. This is not true. A price mechanism is vital--no other way has ever been found or is likely to be found to allocate and direct goods, services, and labor efficiently to meet the needs of consumers. Administration officials know and understand this fully and have a keen appreciation of the role of prices. The wage-price freeze is not intended to convey in any sense the view that we can and should move to some alternate means of directing our production and allocating our output.

Nor is the President's program intended to suggest that "old style" monetary and fiscal policies no longer work. They are still potent--very potent. The problem today is that we are harvesting the results of the impropriety of our economic policies of the mid-1960's. Consider the sharp escalation in federal expenditures set in motion during 1965-68 by the escalation in Viet Nam, by heavier human resource spending at home, by the failure to tax heavily enough, and by the responsive accommodation of the Treasury's needs in the form of monetary expansion. The increases touched off effects on income and expenditure that were to manifest themselves over an extended period.

It was not expected that the steps initiated in the late 1960's to battle the waves of excessive expansion would quickly register. But the degree of the excesses and the stubbornness and tenacity of the forces were not sufficiently recognized. Government economic policies through mid-1971 were contributing mightily to a solution of the problem. But they were not enough. Results were too slow in coming. In his new program, the President is trying to accelerate the re-adjustment that these policies alone couldn't quite provide within any reasonable time frame.

In this context, it would, I think, be helpful to review for a moment the circumstances leading to the President's historic announcement of August 15. Doing so will help to make clear the role that the wage-price freeze is expected to play.

I think that most observers of the business scene during the first 7 1/2 months of 1971 would say that we were in the doldrums.

There had been some improvement from the recession trough of November 1970 as dated by the National Bureau of Economic Research. But the rebound was not great enough to significantly reduce unemployment, and manufacturing capacity utilization had been hanging around 75 percent. Sales of domestically produced automobiles had shown a progressive decline in the seasonally adjusted annual rates since February, and despite continued modest growth in retail sales, the consumer was squirrelling away record saving.

Some economists maintain that the recovery, and retardation of price inflation, was "on track" or "on schedule." But it takes ingenuity to reconcile these views with the profile traced by the economy since the peak reached two years ago. Employment in August was 700,000 below the March 1970 peak. Industrial production, despite some recovery, was still off 5 percent from its 1969 peak. Manufacturers' unfilled orders were still declining in July. Nevertheless, average prices in the private economy advanced at a 5 percent annual rate in the second quarter of 1971, slightly more than in the year 1970. Although the rise in the price level abated somewhat in July and early August, it was still uncomfortably rapid. All of these developments compared unfavorably with the performance of the economy in earlier postwar business cycles.

At the same time our foreign exchange position was deteriorating rapidly. Not only was our balance of payments deficit worsening, reaching a record annual rate of deficit of more than $20 billion in the second quarter, but even our trade balance, which had always been considered a plus item, plunged into deficit as well.

But there were some bright signs in the picture. Housing starts were above any levels achieved in the last decade and were approaching record levels. Retail sales, particularly of nondurables as well as durables other than autos, were growing significantly. The 12 so-called leading economic indicators were pointing up except for a brief pause in June. There were some indications that steel buying, though very low right after the wage contract settlement, was higher than the steel companies had expected.

In short, then, the state of the economy was a little better than it had been. It showed some signs of more rapid improvement ahead. But it was not nearly as good as desired. And in particular, despite the slowness of the recovery and the relatively high unemployment level, there had been a disappointingly slow decline in the rate of price increase. It was becoming increasingly clear that we were going to have to wait a long time for the natural forces in the economy--even with the stimulus already provided by fiscal and monetary policy actions--to carry us back to good growth rates, acceptable unemployment rates, and reasonable price stability.

So now we enter what will generally be agreed as a new era. Tax reductions, government expenditure cuts, investment tax credits, import restrictions--even a floating dollar--have precedents. But the imposition of a freeze on all prices and wages in peacetime is something new.

The President's actions were all aimed at one or more of the current economic problems of the country. They will supply that extra effort required to put us back on the track. The obvious thrust of the program is to accelerate the achievement of a more stable price structure with high levels of employment and a reasonable balance of payments position.

The evidence of the past few years indicates that inflation tends to feed on itself. Once there is an extended period of price rise, people act on the expectation that the trend will continue indefinitely. Labor starts asking for higher wage increases, not just for the current period, but with a guarantee two and three years ahead. Businessmen accede to these demands with decreasing resistance because they anticipate that a rising price level will provide the money to pay the higher wages without affecting profit margins. Interest rates rise because the investor wants protection against the deteriorating purchasing power of his cash. And so it goes through all aspects of the economy.

We have been going through an economic recession which most economists expected would strongly dampen inflation. High unemployment is supposed to lower the pressure for wage increases. Low capacity utilization should lower the pressure for wage increases. It would appear, however, that the public's expectation that these conditions were temporary and that we would soon be back to super boom conditions was a stronger force than any one realized. Something more was required.

A 90-day freeze is not going to suddenly change these expectations standing by itself. It was immediately clear that it must and would be followed by some sort of transition controls leading back to a free market economy. As the realization of this fact sinks into all of us, the expectation of inflation should diminish, and the basic forces which have been relied on to slow the price increase trend will have time to pervade the economy.

A good case can still be made that the underlying operation of the economy, running along with continuing underutilization of both our manpower and capital capacity, could have eventually brought an end to the inflationary trend. But patience cannot be infinite. Nor--even if it were--do I believe that this was a practical political solution to the problem. By this statement I don't mean the narrower consequences of the 1972 elections, important as they are. I mean that as a society, we are no longer willing to accept a 7 percent or higher unemployment level. Nor are we willing to place the major burden of the penalty for our past errors on the segments of our society least prepared to carry that burden. The alternatives were (1) steps to drastically stimulate the economy regardless of the inflationary forces turned loose, or (2) the direction the Administration took on August 15.

Had our international balance of payments problem not accelerated, the initial step taken on the wage and price front could perhaps have been much less drastic than the freeze which has been imposed. The erosion of our trade position, however, has resulted in part from the gradual but steady deterioration of the price balance between our competitors abroad and ourselves. The freeze contributes to the solution of the international problem in two ways. First, it will inhibit the rise of our export prices, thus improving our competitive position. Second, it clearly signals to those countries who will be cooperating with us in solving the international monetary problem that we are serious in trying to stem the forces that have brought the current disarray into being.

The President's internationally oriented steps--the import surcharge and the discontinuance of gold convertibility--are both obviously aimed directly at the heart of our balance of payments problem and at bringing significant improvements in the international monetary system that we have lived with since the end of World War II. Both steps are aimed at prodding the other nations of the world into a more equitable and rational stance in world trade. The thrust of the program is threefold. First, it is aimed at a mutually agreed realignment of the values of foreign currencies relative to the dollar in a way that more truly reflects real purchasing power of those currencies in today's market. Second, it is aimed at making future adjustments in foreign exchange rates easier and more automatic. Third, it is aimed at reducing or eliminating nontariff barriers which other nations have erected against U. S. products.

The import surcharge is clearly a bargaining tool. As such it carries important risks. The objective of our whole foreign trade policy during the past generation has been freer world trade. That objective is unchanged. Higher tariffs diminish freedom of trade. The surcharge is clearly intended to facilitate more rapid accommodation to the U. S. position on exchange rates and related problems. It is not justifiable as a shift toward a protectionist policy. It is possible, of course, that other countries will take retaliatory measures rather than negotiating. Despite the extreme complexity of any such negotiations, and many expressions of dispair as to the impossibility of the task, the general reaction is still the constructive course of seeking adjustment instead. We should remember, of course, that the duration of the surcharge is quite independent of the 90-day termination announced for the wage-price freeze.

The President's proposed reductions in taxes and government expenditures go hand in hand. What is intended is a transfer of purchasing power from the government to the private economy, with the intention of providing more jobs for hundreds of thousands of Americans by stimulating capital investment spending, the auto industry, and consumer purchasing. The immediate general support for these changes by congressional leaders implies that the tax changes proposed will be forthcoming, although not necessarily in the same form as requested. The capital goods industry is obviously a sector of the economy which has been severely depressed by the general sluggishness of the economy, and it is obviously one of the objectives of the new tax policy to stimulate that industry. However, the reasons for the tax change go much deeper. The intent is to encourage all industry to increase productivity by replacing obsolete machinery and equipment. This increase in productivity will contribute to both price stability and export competitiveness. Here, again, we see the kind of reasoning which led to the combination of steps taken on August 15.

The outcome of the President's program will depend on four factors:

1. The degree of success in convincing the country generally that the program will work, changing expectations on the rate of future prices accordingly.

2. The way in which the Congress responds to the President's tax recommendations.

3. The kind of program on wages and prices which follows the 90-day freeze--Phase II.

4. The success in negotiating a new international monetary structure which is more responsive to a changing world.

It is certainly clear that the broad initial response to the President's program throughout the country was excellent. It is also clear that, to date, the freeze has been conscientiously observed. I think, too, that most people are now prepared to accept a follow-up program which, though less restrictive than an across-the-board freeze, will limit price and wage movements for maybe a year or more after the freeze itself ends. This means that both price and wage levels will, looking down the road, be noticeably below levels that would have been reached had we continued on the course we were following up to August 14. The public's expectations should be significantly altered in that period of time.

I think that the Congress will give the President much of what he requested. If there are any differences I expect them to be in the direction of more economic stimulation rather than less. For example, the investment tax credit could be made effective for equipment installed after April 15, 1971 instead of August 15. Also, more tax relief to individuals may be granted by increasing the standard deduction, by advancing the effective date for increased personal exemptions, or by other means. It also is possible that the scheduled increase in social security taxes next January will be postponed. On the other hand, I think it unlikely that congressional action will be firm enough to fully support the President's desires to obtain a reduction in expenditures equal to the tax cut. We are, therefore, very likely to see a greater deficit than the President has estimated unless the economy picks up faster than the Administration's own revenue estimates assume.

The form which the post-freeze policy will take cannot yet be discerned from Administration statements in more than a general way. Several things are, however, becoming evident. The transition period can reasonably be expected to last for some time. This means that congressional action will probably be necessary--although not during the current session--since the President's wage-price control authority terminates next April. It also now appears that Phase II could well involve some adjustments in wages based on productivity measures and consumer price index movements. Price adjustments may well be restrained by some link to actual cost increases.

I also suspect that we may be headed toward some re-examination of our approaches to the collective bargaining process. The Congress has shown itself ready to intervene directly in the case of the railroads, although thus far only with temporary measures. But it is increasingly clear that public pressure is building up for some more lasting machinery to prevent shutdowns in major segments of the economy, particularly in those activities which have immediate impact on the general public such as transportation, mail service, public safety, and other critical public services. I have no idea what form these changes will take. But I expect them to be broad enough to affect more areas than those that immediately come to mind.

The restructuring of the international monetary system will be a slow, painstaking procedure. Until it is well underway, it seems unlikely to me that the surcharge can be lifted. Despite the steps already taken of freeing the dollar and the surcharge, it seems to me unlikely that our international payments balance will move into surplus during the next year or so, even if net export figures improve significantly.

Now what does all of this mean as far as general business conditions are concerned? I am personally optimistic that the new policies will succeed in speeding up the growth of the economy--and with a lower rate of inflation than has been the case without them. The impact on the broad measures of economic activity is, of course, negligible during the current quarter, half of which was behind us when the freeze was imposed and the course of much of the rest of it predetermined by existing orders and plans. The fourth quarter should show more--but still a relatively small--effect. Early 1972 will tell us much more, I am sure.

This optimistic assessment follows largely from my view that it was necessary to shake up the inflationary expectations so prevalent in the economy and to do it on a world-wide scale. If that part of the President's program is to work, it must be clear to everyone that the Administration is and will be taking the steps needed to control the corroding influences of accelerating price inflation. The President has already indicated that there will be a Phase II with teeth in it. The resolve to act is there.

But the post-freeze period will show positive results only if accompanied by continued strong public support and by appropriate monetary and fiscal policies. It must be clear to everyone that the government is not simply adjusting the thermometer of prices but that the patient's fever is being brought back down to normal.

If this is not done, the effort will not have been worthwhile. We will either be off and running again on price advances or forced to limp along in an economy with a market mechanism muffled in an inefficient manner.

But I believe that we can, and will work on the illness--not just the symptoms. The fever will subside. Then, the effort will have been worthwhile. The actions will have hurried up the price expectational change, and we will again be able to get back to an economy where the market system shows its true vigor as we enjoy sound economic growth in the years ahead.