ECONOMIC EXPANSION IN 1972

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It is indeed a pleasure to have been asked by the local chapter of the National Association of Accountants to speak to you this evening. I always feel at home with accountants since I had an accounting major in college myself. But I must confess I never went through the rigors of preparing for the CPA exam. The accounting background has, however, been very helpful to me, as an auditor for the Washington State Tax Commission, as staff director of President Johnson's Commission on Budget Concepts, as director of the U. S. Bureau of the Budget under President Nixon, and in my current position.

I don't intend to talk about accounting problems, practices, or procedures tonight. Nevertheless, I should at least make reference to the statement of earnings and expenses of the Federal Reserve Bank of Chicago. Like many other organizations, we just closed our books the end of December in my shop. We didn't do as well in 1971 as in 1970--our net earnings before payments to the U. S. Treasury and dividends paid to member banks were down about $20 million. But, of course, interest rates were lower--and because of the international situation our earnings on foreign currencies dipped. Nevertheless, our bank had total current earnings of about $610 million and operating expenses of only about $46 million. There were a few adjustments but we had a profit margin of 94 percent--and we weren't even trying to make a profit. We distributed about $6 1/2 million to our stockholders--the roughly 950 member banks in Indiana, Illinois, Iowa, Michigan, and Wisconsin--transferred a little over $5 million to our surplus. The remainder, $564 million went to the federal government. And yet even with that handsome looking profit margin, I can assure you we have just as tough a cost control program as any one of you.

But as I've said, we weren't trying to make a profit. We were trying to do something else--and that is what I want to talk to you about this evening.

Nineteen seventy-one was quite a year--quite a year for businessmen, consumers,and governments--quite a year for the domestic economy and the international economy--quite a year for prices, unemployment, and economic growth. No matter how you cut it--quite a year.

It started off with a general acceptance of the idea that we were in the recovery stage of the business cycle--the first cycle since 1960-61 and the fifth cycle in the postwar period--but with considerable disagreement as to the most likely or most desirable speed of recovery in real output--or decline in the rate of inflation. Remember the consensus forecast of around $1,050 billion for the gross national product for 1971? Do you remember $1,065 billion--the optimistic forecast? Well it looks like the consensus was about right. Maybe a little high now with the revisions in the GNP data announced last Friday (we'll probably show about $1,047 billion in GNP for 1971 now) but close. The significant recollection is that a modest recovery pace had been expected and that's what we got. At the Fed we aimed at providing enough money to stimulate economic recovery in 1971, but not too much, which would reinvigorate inflationary pressures. I think we succeeded in that, with a little over 6 percent increase in the narrowly defined money supply, 11 percent in the broader money supply (which includes savings in banks as well as checking accounts and currency), and 7 percent in member bank reserves--the factor the Federal Reserve can influence most directly.

In the closing months of 1971, the economy appeared to be emerging, after a series of false starts, from a lethargy of more than two years. Retail sales were strengthening, employment was rising gradually, residual construction was at record levels, and prospects for business investments in inventory and plant and equipment were improving.

The decline in real activity from the 1969 peak to the 1970 trough had been shallow compared to earlier post-World War II recessions. But business recessions have two basic dimensions--amplitude and duration--or depth and length, if you prefer. The time the economy has operated well below potential has been of unprecedented duration for the postwar period. Among major sectors of the economy, only residential construction was operating at virtual capacity in 1971. Moreover, output in some manufacturing industries was less in 1971 than in 1970.

During the first half of 1971, the continuation of rapid price inflation in the face of substantial unused resources of manpower and facilities raised a growing chorus of dissatisfaction. Domestic problems were compounded by the nation's worsening international trade balance, and increasing doubts concerning the value of the dollar relative to other currencies. Impatience with the apparent ineffectiveness of monetary and fiscal policies in restraining inflation and restoring full prosperity brought widespread demands for more drastic action.

On August 15, the President announced his dynamic program to deal with the nation's economic problems. He declared a 90-day wage-price freeze, suspended the convertibility of the dollar into gold, and imposed a 10 percent surcharge on most imports. He also proposed certain government expenditures and asked Congress to provide tax relief. The "New Economic Policy," received general support.

Following August 15, a number of bodies were established to administer direct controls. They included the Cost of Living Council, the Wage Board, the Price Commission, and the Committee on Interest and Dividends. In general, the public cooperated very well with the 90-day wage-price freeze, and with the rules and regulations of Phase II, which started November 14.

Advances in prices and wages, on the average, had slowed somewhat prior to August 15, and it is probable that this trend would have continued. But under controls, the rise in consumer prices appeared to have stopped almost completely.

Nineteen seventy-one was also quite a year in international monetary affairs. Not since the early Thirties had the world been confronted with an international financial crisis of such scope and severity. For a period of several months, from August until late December, foreign exchange markets were in an unsettled state. Uncertainties concerning the value of the dollar relative to other major currencies hampered foreign trade and the international flow of funds. Concerned with the threat to the collective prosperity of the free world, monetary authorities of the major noncommunist countries applied themselves to the task of reestablishing a smoothly functioning international payments mechanism.

Clearly, so much happened to our economic life in 1971 that "history" alone could take up my time this evening. But just as clearly, the events of 1971 cannot be ignored as we look ahead into 1972. It is after all the prognosis for the success of wage and price controls, the provision of tax incentives, and the realignment of world currencies that will determine the unfolding of economic developments in 1972.

Let my say a few words about wage and price controls. I have no great enthusiasm for such restraints. But I fully support the efforts that are being made to stop the rise in prices and change the expectations about the prospects for reasonable price stability. There is no question that whatever success these direct controls achieve in the short run, over the long run such measures will be associated with inequities and inefficiencies in the allocation of income and resources. Administration spokesmen have emphasized that the controls are temporary expedients, intended to pave the way for a return to a freely competitive market. I agree with this position.

And this appears to be what is happening in actual operation. The trend in rulings of the Price Commission has been toward flexibility--flexibility to permit businesses to operate with a minimum of interference in making specific decisions. The Wage Board took into account the Price Commission's goal of restraining average price increases to 2.5 percent, setting its general standard of 5.5 percent per annum increases in worker compensation. The Board assumed a rise in output per man-hour consistent with the historic trend of 3 percent. The wage formula is the sum of the anticipated increase in average prices and the anticipated rise in productivity. Allowances in wage rulings were to be made for hardship cases, and the need to "catch up," as in the case of price decisions.

The basic policies of the Price Commission, the Pay Board, and the coordinating Cost of Living Council are intended to create an economic framework that approximates free market conditions, overriding the monopolistic power of some elements in industry and labor. For this reason, administrators have followed a strategy of concentrating on the largest units in labor and industry. The measurement of success in this formidable undertaking will not be clear until 1972 is well advanced.

As I mentioned earlier, the volume of total activity in 1971 was about in line with the median forecasts made at the start of the year. However, there was a general tendency to overestimate activity in the manufacturing sector, and to underestimate the persistence of the problem of unemployment. In addition, most projections envisaged a more pronounced slowing of price inflation than actually occurred, at least prior to the introduction of price and wage controls. Of course, such important developments as the imposition of direct controls, the provision of new tax incentives, the international monetary crisis, and the realignment of world currencies were not foreseen when economic forecasts for 1971 were constructed.

With so much behind us, perhaps we can be more confident that a similar set of unusual events will not confront us in 1972. And, interestingly enough, we do see a fairly tight grouping of forecasts for this year. In my view, the chances are very good that we will achieve a current dollar GNP in the $1,140 to $1,150 billion range--

around $100 billion higher than in 1971. Like so many others, I look for the major strength to come in the consumer sector and residential construction with strong assists from fixed investment, inventories, and government.

Consumer purchases of nondurable goods were unspectacular throughout 1971, rising less than disposable income. But purchases of major household goods--including household appliances, furniture, and color television--were at very high rates, showing renewed strength before the auto sector did. Manufacturers' shipments of household durables exceeded the year-earlier level by about 20 percent from August through November. Part of the strength in household durables probably resulted from the need to furnish newly completed residential units, up sharply in the second half of 1971. The boom in autos and other consumer durables aided Midwest centers in Michigan, Illinois, and Indiana, which produce a large share of the nation's output of these items.

Consumers played an important role in the improvement in economic activity in 1971, but, on the whole, they did not extend themselves. Many families were saving a larger-than-normal share of their current income, much of this in the form of savings deposits, because of uncertainties concerning job security. Late in 1971, surveys of consumer sentiment showed no significant improvement in consumer confidence, which had been badly shaken by events of the past two years.

Nevertheless, the same factors suggest the possibility of considerable strength in personal consumption expenditures as the year wears on. As business conditions improve generally, consumer confidence should be restored. Sustained increases in personal income and the high level of personal savings accumulated over the past two years are positive factors in the picture. Durables should show further strength from furnishing requirements for new homes and from autos, for which another good year is being forecast.

As 1971 drew to a close, auto industry executives were again optimistic, despite a distinct slowing in sales in December. Sales of passenger cars were projected at 10.5 million or more for 1972, with no further inroads from overseas imports. The import surcharge had been removed in late December, but currency realignments would have the effect of raising prices of imports by about 15 percent, and, in addition, foreign producers have experienced even more severe upward cost pressures than have U. S. producers. Truck sales were projected for 1972 at about 2.2 million, another record, with demand for heavy trucks especially strong.

I am also optimistic on plant and equipment spending for 1972. In the second half of 1971, accumulating evidence suggested that a general revival of plant and equipment spending had begun. Total production of producer equipment rose slowly but steadily after midyear. Surveys of business intentions indicated that total outlays on plant and equipment would rise 8 to 10 percent in 1972, about as much as the rise anticipated for the gross national product. Such a prospect, of course, does not suggest a new surge in plant and equipment spending, but it indicates solid improvement in place of the decline of 1970 and early 1971.

The major factor determining the trend of capital outlays is the rate of growth in demand for goods and services produced by these facilities. But profit prospects can also be enhanced, at least temporarily, by favorable tax measures. In June 1971, the Treasury published its Asset Depreciation Range System (ADR), which was approved in essentially the same form by Congress late in the year. These rules permit many buyers to write off purchases of new equipment for tax purposes at a rate 20 percent faster than allowed formerly. In addition, the Congress approved a reinstatement of the 7 percent investment tax credit (retroactive to April 1, 1971) that had been repealed in 1969. The investment tax credit (approximately equivalent to a price cut of similar proportion), coupled with faster depreciation, will stimulate some marginal investments. Finally, U. S. equipment producers will be aided by the realignment of international currencies that makes the prices of their products more competitive with those of foreign companies.

The critical element for 1972 is, I think, the progress we can make toward reducing unemployment. Unemployment has continued relatively high mainly because of the failure of production to rise at a faster pace. But the idling of marginal facilities with high labor inputs, and the usual tendency of output to rise faster than employment in the early stages of a business revival (with resultant increases in output per man-hour) have minimized the need for additional workers. In addition, many employers have been under pressure to improve reduced profit margins and have been operating under policies that restrict new hirings more closely than in the past.

Consequently, I expect the unemployment rate to be fairly sticky--especially in the first half of the year. And I suspect that this will result in increased pressure for a new look later in the year at our economic policies--are we focusing properly? It would appear, after all, that we are placing a significant amount of emphasis on the machinery for wage and price control. The press watches and announces every action of the Pay Board, Price Commission, and the Cost of Living Council. International developments have also been in the spotlight.

Certainly, the unemployment rate level has not been ignored, but think for a moment about the emphasized thrust of national economic policies--and I'm thinking of the press and public emphasis--not the Administration's emphasis. The unemployment rate has been placed in the role of the residual--the "fall-out," the unavoidable result of efforts to fight inflation and re-create a viable international economic system. But remember that the NEP had a less myopic intent and that efforts to achieve a higher level of activity and employment were and are very much a part of that program.

All I intend to convey by this is that I think you will see evidence of a public recognition lag as we move on into 1972. The increased pressure to "do something about unemployment" will come too late in the sense that actions will have already been taken. There is no such thing as "instant" economic policy. The monetary and fiscal policies necessary to provide maximum economic expansion with minimum price pressures for this year have already been largely charted. And you can be assured that the Federal Reserve will do everything it can to promote maximum economic recovery with minimum inflation.

Even the most optimistic do not argue that we will close the gap between potential and actual output in 1972. Even the most pessimistic do not argue that we will fall behind 1971 growth this year. Between the two extremes, I look for solid economic expansion in 1972 and expect that we will have reduced unemployment without increasing inflationary expectations in the year ahead.