An Economic Overview

Remarks by Robert P. Mayo
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It is a pleasure to be talking with you today about our economic situation. Investment forms the mainspring of our economic growth, and your industry has been an ever growing source of the funds needed to replenish and expand the nation's stock of capital.

Today I want to review with you some of the problems which developed in our economy during the middle Sixties; the policies of the administration aimed at correcting those problems prior to the introduction of controls; and Phases I and II of the control program. Then I want to take a look at where the economy stands today, together with my own outlook for the future insofar as it can be judged from what we now see. This is a large order. Yet I feel that a little historical perspective first may be helpful.

How we got where we are

The United States collects, organizes, and disseminates more and better economic statistics than any other nation in the world. At least one statistical news release makes financial page headlines every day. Furthermore, each of these releases is interpreted and analyzed with the same kind of fervor and detail as the ancient

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Greeks used in interpreting the babblings of the priestesses at Delphi. As one reads the various interpretations of all the experts who profess to being able to read these omens, it becomes evident that the meaning behind these daily magic numbers is at least as cryptic as the meaning of the utterances of the ancient oracle.

Paleontologists are able to reconstruct a complete skeleton of an extinct animal from the information gained by examining one fossil bone. Good for them! We economists can't! Only by examining a wide variety of data series, each in its proper historical context, can we develop a reasonable understanding of what has happened in the economy, evaluate where it stands now, and make a practical judgment of its likely future course.

Every business cycle of contraction and expansion has its own peculiarities. Yet there are also many similarities. We can still learn a great deal from the past. Business cycles have been with us as far back as we have records. If we just look at the U. S. economy over the 107 years since the end of the Civil War, there have been 25 business contractions, or about one every four years. So they are hardly a rare occurrence. Despite these contractions we have had an overall trend of economic growth during this century which has transformed us from an essentially agrarian nation into the World's leading producer and consumer of all sorts of products and services.

During these same 107 years, we have had price cycles, too. On balance, prices have about tripled in this 107-year period, an average rate of increase of about 1 percent each year. The bulk of this price inflation occurred in four major jumps and one minor one, all five coinciding with periods of war. Each time the same cause

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was there--military demands superimposed on normal markets. We have not relied heavily enough on taxes to siphon off consumer and business demand, so total demand pressed hard on our capacity to produce. Thus the strong inflationary pressures of the late 1960s should not have come as any great surprise.

The 1930's are, in many ways, a crucial period in dividing the past from the present in economic history. The events of the Thirties were largely responsible for the politicizing of the economy. The concept of the Federal Government as the primary device for regulating the economy, and the injection of governmental action into almost every aspect of economic life--agriculture, labor relations, investment, you name it--were born and grew to early manhood during that period. These concepts matured during World War II and the postwar period. The key legislation was, of course, the Employment Act of 1946, formally recognizing the responsibility of the Federal Government to promote maximum employment, production, and purchsing power. This was the law that created the Council of Economic Advisers in the Executive Office of the President, the requirement for the annual "Economic Report of the President," and the Joint Economic Committee of the Congress. While not stated implicitly in the Act, its philosophy implied that it was the duty of the Federal Government to quickly shore up the economy when recession threatened, and to control price inflation.

Since the passage of this Act, conscious use of varying combinations of monetary and fiscal policies has occurred in every business downturn: 1949, 1953, 1957, 1960, and 1969. These downturns were typically caused, at least in part, by deliberate policy aimed at slowing or halting price inflation. During this entire postwar period,

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the efficacy of government action through these channels was thoroughly demonstrated, even though our aim in hitting exact targets certainly has not been perfect.

The expansion which began early in 1961, and which peaked in late 1969, was the longest period of continued growth in our history. By most measures, it was a period of excellent economic performance, although we often forget that, despite stable prices, unemployment averaged 5 1/2 percent of the labor force during the first half of the period--and we can't forget the inflation in the second half. During the latter part of this period, fiscal policy became highly stimulative in the face of low unemployment and high utilization of our other resources. The Vietnam war acceleration, and Great Society expansion combined with lowered tax rates, fueled an inflationary cycle which later tax increases failed to dampen. In the fourth quarter of 1968, the consumer price index was 13 1/2 percent higher than it had been in the fourth quarter of 1964, and was rising at a rate of more than 4 1/2 percent per year.

At the same time that inflation was developing as the principal domestic economic problem, our balance of international payments problem was looming on the horizon. At the end of World War II, the United States was virtually the only country with significant financial reserves. It owned the lion's share of the gold stock and had large claims against almost all other countries. Principally through Marshall Plan Aid and military assistance, this nation provided the capital for world-wide revival of industry and trade. This situation persisted up to the end of the Korean War, when our reserve asset position was still twice as large as our liabilities to foreigners.

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However, the end of the conflict coincided with the beginning of a continuing trend toward decreasing reserve assets and increasing foreign claims, primarily because of grants and military expenditures. This trend accelerated in the late 1950s as the development of the Common Market made private investment overseas more attractive. The addition of private investment and the substitution of foreign production for exports grew progressively more important during the 1960s so that, by the end of 1968, foreign claims were twice as large as reserve assets, a complete reversal of the ratio in 15 years. Indeed, in the absence of either an adjustment in exchange rates or drastic restrictions on dollar flows, no turning back was possible. Thus the stage was set for the events of the past three years.

Administration policy prior to Phase I

When the Nixon Administration took office in January 1969, it was clear that it viewed inflation as a serious economic problem. Immediate steps were taken to provide a restrictive fiscal policy at least through 1970.

This restraint was achieved through three principal actions:

- Extension of the surtax
- Restraint on Federal expenditures
- Deferral of a significant volume of new Federal supported construction.

Fiscal restraint was accompanied by firm monetary restraint on the part of the Federal Reserve System. At the time, it was anticipated that, by an extended period of slower economic growth, the inflation rate could eventually be brought down to a more normal level without producing the undue hardship accompanying severe unemployment.

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It was recognized that this would be a long, slow process, but we all know now that almost everyone in the economic community, both in and out of government, misjudged both the pervasiveness of the inflationary cycle and the momentum of wage increases at the time. While there was some slowing of the rate of growth, expansion of business activity persisted through the first three quarters of 1969, and, as measured by annual change of 6.1 percent in the consumer price index, 1969 was the top year of the inflation spiral, with the peak actually occurring in the second quarter.

At the beginning of 1970, real growth in output was slowed to near zero. The policy objectives for the year were to take actions which would revive output growth to a moderate pace in the second half, but slow enough to continue the reduction in the rate of price advance. To this end, a more neutral fiscal policy stance was adopted, and monetary policy, which had held money supply growth near zero during most of 1969, was relaxed moderately. Probably no year in recent history has seen so much policy frustration as 1970. The few signs of second half recovery were buried by the lengthy auto strike. The unemployment rate moved up steadily to slightly over 6 percent and, despite the lack of growth, the consumer price index rose 5 1/2 percent, only slightly less than in 1969. One major contributor to both the larger than expected increase in unemployment and the failure to achieve growth during the second half of the year was the steady slowdown in military expenditures and gradual reduction in the size of the armed forces.

Despite the problems of 1970, it appeared to some at year-end that the major policy objectives had been accomplished. The rate

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of inflation was slowing down without as severe unemployment as had occurred in 1957-58 and in 1961, and the impact on primary breadwinners was significantly less severe. As we entered 1971, further progress in the anti-inflation effort, accompanied by significant business recovery, was anticipated. The policy goals set in early 1971 were ambitious. It was expected that a less restrictive fiscal policy and a more relaxed monetary policy would result in sufficient growth in output to reduce unemployment to the neighborhood of 4 1/2 percent by year-end, while the rate of inflation as measured by the GNP deflator would be slowed to 3 percent. During the first half of the year it looked very much as if at least the second of these two objectives might be met. However, output was sluggish even though monetary growth was larger than expected during the period, thus raising fears that inflation would be rekindled.

During the first quarter of 1971, which included the rebound from the auto strike, output rose at an annual rate of 8 percent, but this slowed to just below 3 1/2 percent in the second quarter. As a result, the unemployment rate seemed glued at 6 percent. Preliminary GNP data for the second quarter became available in the latter part of July. Thus the stage was set for the decisive action of August 15.

The international monetary situation also played a large, and perhaps decisive, role in the mid-August pronouncements. During 1969 and 1970 the Administration was, indeed, deeply concerned about the continued worsening of our balance of payments situation. Except for measures which involve major interference with trade flow, such as currency controls, drastic tariff changes, and quotas, there are

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only two mechanisms by which payments imbalances can be corrected. One is to change domestic policy so that imports tend to be reduced and exports increased, while countries with surpluses can adopt expansive policies. The other is to alter exchange rates to improve the competitive position of deficit countries. For a major nation like the United States, whose currency has become a world-wide reserve currency, the second of these alternatives, while it is the more desirable when unbalances are prolonged, is available only with the consent of the rest of the world. Our major trading partners were not prepared to cooperate in this kind of action during 1969 or 1970.

During 1969 our domestic policy coincided with the restrictive policy which was desirable to reduce our international payments deficit, and this probably lowered our outflow below what it otherwise would have been. In addition, revaluation of the German mark and some other currencies in 1969 were of significant assistance. Large outflows occurred in 1970--the year before the storm--but money markets generally remained calm. However, the transfers of U. S. dollars overseas, once highly desired by the rest of the world, had accumulated to the point where the acceleration of the outflow in early 1971, as our interest rates fell sharply below those in Europe, began to disrupt the foreign exchange market. The floating of the German mark in mid-May was of some help, but by August the pressure for concerted action became overwhelming. Thus, while some of the steps taken by the U. S. in mid-August were criticized in detail by some of our major trading partners, the general reaction was one of relief and a willingness to renegotiate the structure of international payments, a step that was long overdue.

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Controls

On Sunday evening, August 15, 1971, the President announced a dramatic shift in policy for both the domestic economy and for the free world's financial structure. In the nine months that have elapsed since that time, so many events have occurred that it seems worthwhile to look back and review a bit. The basic elements of the President's program, largely concurred in by the Congress, were:

1) A wage, price, and rent freeze;
2) Suspension of convertiblity of the dollar into gold;
3) The import surcharge;
4) Tax reduction.

It was obvious that such a rigid control on prices and wages could only last a short period of time without severe inequities.

The "Freeze" was a success--largely because it didn't last any longer than necessary. Of nearly one million inquiries handled during the freeze period, all but 50,000 were requests for information, not complaints. Over 60 percent of these complaints turned out to be unjustified. Of those that were appropriate, virtually all were discovered to result from misinterpretation and were resolved voluntarily. Out of this total, plus the result of 85,000 spot checks by Internal Revenue personnel, only 31 cases were in preparation for litigation or already before the courts when the freeze ended.

Congress implemented the President's tax recommendations, although it took several months to do it. Personal income tax savings were produced by increasing exemptions, business tax reductions reflected reinstitution of the investment tax credit, and excise taxes

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were removed from automobiles and light trucks. The result was a greater total reduction than the President had requested, but basically in line with his proposals.

Phase II, which has now been in effect for just over six months, was designed to insure that we bring inflationary expectations down to a level where normal market mechanisms can again provide adequate insurance of stable conditions. During its initial stages, the freeze was, in effect, continued while the Pay and Price Boards were set up and staffed, and while workable targets were established.

Meanwhile, on the international side, the immediate result of the imposition of the surcharge and the stopping of dollar convertibility, was that most major countries permitted their currencies to rise in value against the dollar--yet without permitting a completely free market situation to develop. Development of exchange rate negotiations took a long time but the problems were complicated. Each nation had to consider not only its trade relations and balance with the U. S., but also with each of its major trading partners--plus its own internal conflicts. Finally, after many meetings and bilateral discussions, the Smithsonian agreements emerged on December 18. The basic features of these agreements were:

1) Agreement on new exchange rate parity levels, generally at slightly higher values against the dollar than prevailed at the time of the agreement.

2) Widening of the control band around the parity value from ± 1 percent to ± 2 1/4 percent, permitting freer adjustment of exchange levels.

3) Change in the price of gold for official transactions to $38 an ounce from the $35 level.

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4) Agreement to conduct continued discussions aimed at further reduction of trade barriers, and at improving the international monetary system to permit par adjustment before major imbalance problems develop.

5) Lifting the surcharge.

The Smithsonian agreements were a major step forward in international monetary relationships. Continued discussions on trade and the adjustment mechanism are still in the early stages. Yet the parts of the agreement already implemented suggest that the next several years will see a gradual restoration of the U. S. reserve position to a more tenable level, and that exchange crises such as occurred in the summer of 1971 are less likely to occur again soon.

Negotiations have continued since the end of the Smithsonian meetings toward setting up a broader forum than the ten leading trading nations to carry forward the development of an improved international monetary system. It seems likely to me that the group will be expanded to include lesser developed country representation, and that substantive discussions on the main issues can be expected shortly.

Business conditions since the beginning of the freeze

The third quarter of 1971 was half over when the freeze began. As might be expected, the most immediate impact was on the rate of price increase, with little or no effect on output growth. A second effect of the new policy was the record surge in auto sales, which changed 1971 from a moderately good sales year prospectively into an excellent year for the industry.

The total impact of the new policies on the economy to date is still hard to evaluate. Although growth was slow in the second and

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third quarters of 1971, there were signs of acceleration, and it is very difficult to estimate what would have occurred in the economy in any case and what resulted from the imposition of controls. The picture is further clouded by the dock strikes, the need to work off steel inventories accumulated in early 1971 in anticipation of a steel strike, the bubble of price increases which followed the freeze, and the wage settlements permitted beyond the established guidelines which were based on prior negotiations and on achieving equity with pre-freeze settlements.

Nevertheless, there has been an overall slowdown in the rate of price increase during the total control period. The consumer price index increased at an average annual rate of 2.8 percent for the seven months since the imposition of controls, whereas the rate for seven months preceding the freeze had been 3.9 percent. And despite our discouragement on price trends, we've still done a better inflation-control job this past year than our world trading partners.

Total output for the two complete quarters since the freeze began have shown good, but not spectacular real growth: 5.8 percent in GNP in the last quarter of 1971 and 5.3 percent for the first quarter of 1972. Residential construction continued to soar. Auto sales continued strong, and a gain in market share of domestic vs. imported cars has been achieved. Truck sales have been smashing old records. Orders and output have been rising in almost every sector of the economy. Profits are rising from their record lows. By almost every measure, business and consumer confidence are both rising. Business investment spending intentions project an 11 percent increase above 1971. The consumer,

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too, is showing more willingness to spend, with good gains in retail sales since the beginning of the year, and with a decrease in the savings rate in the 1st quarter following a long spell when savings were at record levels.

One must conclude that the last two quarters have been periods of solid economic growth--the kind of growth which can form a firm base for future progress. The momentum developed in these two quarters should carry forward through 1972 and into 1973. The Administration's fiscal policy is aimed at sustaining the momentum of economic recovery, and the Federal Reserve Board's monetary policy has provided for money supply growth, in my opinion, appropriate to economic expansion yet not stirring up new inflationary fears. The Administration still hopes to reduce the unemployment rate to the neighborhood of 5 percent--and to decrease the inflation rate to below 3 percent--by year-end. They still have a fighting chance of coming pretty close.

The stubbornness of the unemployment rate over the past six months has been disconcerting. It is important, however, that we look behind this highly publicized number to see what has been happening in the overall job market. From the end of August, 1971 through this April, our civilian labor force has grown by almost 2 million as the armed forces have been reduced and as people have re-entered the work force when the job market opened up. During this same eight-month period the economy has actually provided more than 2 million new jobs--a remarkable performance and five times as many jobs as in the preceding eight months. It is evident, moreover, that the labor force cannot continue to grow at this rate very long. If the economy continues to generate new jobs at the rate it has over the past several months,

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we should shortly begin to see significant declines in the unemployment rate.

How's Phase II doing?

With two quarters of solid economic growth behind us and the momentum increasing, it is time to take a fresh look at Phase II. The extensive reporting of the welter of details, the complaints about Pay Board decisions, and the seeming endless confusion of policy changes by the Price Commission have produced an unwarranted negative reaction to Phase II. Fortunately, about 64 percent of the respondents on a recent NAM survey viewed wage and price controls as a positive factor in the economic outlook. I agree with this position.

Current wage and price controls are another step in the politicizing of the economy, it is true. They are an extension of the concept that the Federal Government should be a primary device for regulating the economy. But they are extensions in a different direction from many of the steps taken in the past. Most of the earlier injection of government in the economy has been in the form of modifying the outcome of economic processes in individual sectors or markets; for example, through minimum wage legislation, agricultural subsidies or union-management bargaining relationships. These actions have been for the purpose of restraining or modifying particular markets to insure more desirable outcomes. As we try to influence our economy in these ways we have dulled and weakened our more general economic policy tools. Our fiscal and monetary policy stabilization tools work best when markets are freer and less encumbered. Our ability to hit our targets with a given measure of fiscal or

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monetary stimulus or restraint is affected when market actions are already inhibited.

If we cannot, for one reason or another, eliminate or overturn the market rigidities and demand influences that allow or perpetuate rapidly rising prices, we can at least try to constrain the economic system to work within broadly acceptable grounds. And this is what we did with wage and price controls. These were established to call a time-out on price advances. They were designed to restore, build, and maintain confidence on the part of participants that the economy is workable; as free as possible from the ravages of inflation. The controls set constraints on the economy so that monetary and fiscal policies could again assert their primacy. They confine--not repress --like stops on a pendulum restrict the limit of swing but not the movement within.

The lessons

The economic events of the past several years offer some important lessons to us as a nation which we can profitably apply toward guiding the future course of our economy.

First of all, the United States is no more immune to the general rules of economics than is any other country--allowing excess demand to develop which severely crowds our production capabilities generates inflation.

Second, while inflation can produce a euphoric atmosphere for a time, it inevitably ends in pain and inequity; there is no alternative.

Third, the longer an inflationary period persists, the harder it is and the longer it takes to halt the tide of price and wage increases.

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Fourth, much of the rest of the world has grown up economically, and world-wide economic conditions must play an increased role in our economic policy decisions.

And finally, the fifth lesson, and in some ways the most important of all, is that we don't really know as much about the use of monetary and fiscal policies in altering the course of our economy as we thought we did a few short years ago. When used restrictively, they do slow the economy down; when used expansively they tend to accelerate the economy. Quantitative precision, however, remains a goal to be sought, not an available tool. Monetary and fiscal policies cannot be expected to guide our economic course from month to month in the way that a modern autopilot guides today's jet planes from minute to minute.

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