Economic Perspectives For 1973

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I want to thank you for the invitation to talk with you today about the economic outlook. The nation's banks and, particularly, their loan and credit officers, serving, as they do, all of the rest of the nation's businesses, need to take a broader view of the whole economy in preparing their plans than any other segment of American industry.

Normally in making an outlook or perspectives talk, I prefer to begin directly with the current situation or the future outlook without any economic history. But just a few weeks ago we passed the first anniversary of the inauguration of a dramatically new departure in American economic policy and this new program has had an important bearing on where we are and where this economy is going. It seems appropriate, therefore, to take a few minutes to look back over some recent economic history.

The period of economic expansion which got underway early in 1961 and reached its peak toward the end of 1969 was the longest period of continued economic growth in our history. For many people, this period now represents the "good old days." Certainly by most measures it was a period of remarkable economic performance. Nevertheless, we should not forget that during the first half of this expansion, although prices were very stable, unemployment averaged about 5 1/2 percent. In the latter half of the period, despite the accelerating demands of the Vietnam War, with its pressure on both manpower and other productive resources, we lowered taxes, and initiated the expansionary Great Society programs, thus starting an inflationary cycle so strong that subsequent tax increases failed to stem it.

Immediately after the Nixon Administration took office in 1969, it pinpointed inflation as the primary economic problem. It implemented a restrictive fiscal policy by asking for extension of the surtax, and restraint in Federal expenditure. Congress, with minor changes in detail, acted on the President's recommendations. At the same time, the Federal Reserve System provided a more restrictive monetary policy to act in unison with fiscal restraint. These policy steps were taken on the assumption that the rate of inflation could be reduced to an acceptable level without increasing unemployment to a level which would produce significant hardship. It was realized that this would be a lengthy process, but I know of no economist, in or out of government, who did not underestimate the momentum built into the trends of both prices and wages. Despite the policy steps which had been taken, expansion of business activity continued, and inflation, as measured by the change in the consumer price index, was at its peak during the year.

By the beginning of 1970, real growth in output was near zero. By use of a neutral fiscal policy and some relaxation of monetary policy, output was expected to revive at a moderate rate during the second half, with continued slowing of the rate of price increase. These expectations were frustrated by the depressing effect of the auto strike and the dislocations caused by the slowdown in military expenditures and reduction of the size of the armed forces. Despite the fact that the unemployment rate climbed above 6 percent, continuing price and wage pressure produced an increase in the consumer price index just slightly smaller than the previous year. Nevertheless, progress against inflation had been made without the severe unemployment which occurred in 1957-58, and the impact on primary breadwinners was significantly less severe.

Except for the immediate recovery after the end of the auto strike, the rate of growth of the economy remained sluggish through the first half of 1971, right up to the President's announcement of his New Economic Policy on August 15. It was clear that we had to accept many more months of substandard economic performance if we were to reduce inflation by conventional policy approaches. This meant that either a different approach had to be taken, or we would have to pay for our past excesses with a prolonged period of 6 to 6 1/2 percent unemployment. This was a price the President was unwilling to ask the nation to pay if another path was available. That path was found in the wage and price control program.

Inflation in the face of unemployment was not the sole reason for the new economic policy. The international monetary situation played a large role as well. The glut of dollars in foreign hands had roots which went back to World War II. While these dollars were welcomed as long as they were the primary source of capital for the rebuilding of foreign economies, it had been apparent for several years that the dollar was overvalued relative to most foreign currencies. However, with the monetary system which prevailed, there was no way to change exchange rates without the cooperation of our major trading partners. This cooperative spirit was lacking until the flood of dollars in the first half of 1971 made concerted action essential.

Thus, the twin problems of the slow response of the economy to the conventional methods of attacking inflation and the massive outflow of dollars in 1971 brought us to the President's dramatic change in policy of August 15, 1971. The final outcome of that new policy lies in the future, but the progress to date is on the record. On the international front, the general reaction was one of relief and willingness to re-negotiate the monetary structure. The first result of these negotiations, the Smithsonian agreement, was a beginning, and further progress was made in the recent meeting of the International Monetary Fund in Washington, D. C., but the major task still lies ahead. A structure must be erected which is flexible enough to adjust to changing conditions without the development of the periodic crises of the past. The recent problems with the floating of the British pound are indicative of how far we still have to go. I am optimistic about eventual success in this most delicate area of negotiation.

The success of the domestic economic program of the past year is written clearly in the whole spectrum of economic data which has become available since last August. The pattern which emerges is clearly one of sustained economic growth, accompanied by the gradual dissipation of inflationary pressures.

The most obvious immediate outcome of the institution of the New Economic Policy was the impact on auto sales. It had been a lackluster year for domestic sales. The average annual sales rate for the pre-freeze part of the year was 8.3 million units, and the sales rate declined about every month from January to August. Imported cars also made continued inroads into the market, achieving a market share that was growing from month to month. This picture was converted after August 1971 into an all-time record domestic sales boom which has continued throughout 1972, with month after month of new record domestic sales. Imports also declined in both absolute numbers and market share. The automobile market of 1972 is a textbook case demonstrating the fact that the old economic laws of supply and demand and the efficacy of price competition have not been repealed. The repeal of the auto excise tax, which lowered the general price level, the revaluation of European currencies, which brought foreign and domestic prices into more realistic alignment, and the introduction of the American sub-compact into competition with the small foreign cars, have all combined both to expand total car sales to new record levels and to increase the market share for the domestic makers significantly.

Housing is another area in which the growth of economic activity has also been dramatic. Housing starts, which averaged just under 2 million units in the first eight months of 1971, averaged 2.3 million units, 15 percent higher, in the eight months which followed, and have continued at well above the 2 million level right up to the present time.

While these two areas show the most dramatic impact, the acceleration in business activity and slowdown in inflation have spread pervasively through virtually all areas of the economy. In the capital goods sector, truck sales have lead the way, and in the consumption sector the leading area has been consumer durables.

The stickiness of the unemployment rate, around 6 percent in the eight months following August 15, 1971, seemed difficult to understand in the light of the strong growth in output that was occurring during the period. It is necessary, however, to look beyond this one statistic toward other aspects of the employment situation to see what was happening. During these eight months, our civilian labor force grew by almost 22 million new jobs, adding about three times as many jobs as the 730,000 added during the preceding eight months. This rate of employment growth substantially exceeds the rate at which the labor force could grow at a sustained rate. Reduction in the unemployment rate was bound to follow.

It is also clear that the rate of inflation was definitely slowed during this period. The average annual rate of increase of the consumer price index of about 3 3/4 percent in the first eight months of 1971 was down to an annual rate averaging 2 3/4 percent in the eight months of September 1971 through April of this year. The GNP price deflator, which grew at an average annual rate of 4.4 percent in the first three quarters of 1971, has grown at an average annual rate of 2.8 percent during the most recent three quarters. It is true that certain uncontrolled prices--and I guess meat prices have gotten the most attention--have grown more rapidly. This has occurred primarily because of a very rapid increase in consumption in the face of supplies which cannot be expanded rapidly. Once again we see a fundamental supply-demand relationship at work.

Thus the period immediately following the new policy announcement was one of solid growth with reduced inflation, so that it is possible to look at the current business situation with considerable satisfaction. The unemployment rate reported the last two months has shown some decline, the most recent retail sales figures show a continuing willingness of the consumer to do his share in furthering growth and housing starts continue at a very high level. New orders for durable goods are now almost 25 percent above the level of the second quarter of 1971 and backlogs have risen about 8 1/2 percent as shipments have fallen behind the pace of orders. All indications are that we are in the midst of a strong economic upturn which has the momentum to continue at least well into 1973.

Nevertheless, there is a black cloud on the horizon--the possibility of renewed inflation. As business conditions continue to improve, demand pressures will begin to be exerted on prices. At the same time, negotiations for a broad range of labor contracts are coming up next year. If prices have risen, it will be very difficult to restrain wage increases to levels which do not, in turn, put further pressure on prices. These are pressures which arise in every period of rapid growth. The problem is more than usually acute at this particular time, because, while we have made progress in the damping of the inflation of the past several years, the battle is still not won. Given the private sector alone, there is a good chance that the battle could be won. The slack remaining to be taken up in productivity and in employment provides some leeway to exert enough countervailing pressure on prices and wages to keep wage and price controls operative.

But we do not have only the private sector to deal with. The real key to whether we can achieve continued growth with stable prices lies in the hands of the Federal Government. Large, recurring deficits in the government sector, as the economy approaches full employment, can lead to only one result: renewed and accelerating inflation.

The immediate focus of most commentators on the Federal budget is the deficit for the current fiscal year. At the time of the midyear budget review, it was estimated that the 1973 deficit would be $27 billion, and that there would be a $3 billion deficit even if government receipts were at the level provided by the economy producing at its full-employment potential. Since that time, new legislation by the Congress has added several billion dollars to the expected deficit, the largest single addition being about $4 billion as a result of the 20 percent increase in Social Security benefits. This is an extremely large deficit, not only by any historical standards, but also in terms of its expansionary impact on the economy. There are economists who would argue that this type of expansionary policy is needed to get us back to a full-employment economy, and I might find myself in sympathy with that concept if this were a one-time situation. However, I am deeply concerned about the longer-term implications behind present expenditure trends. I am concerned, first, because we seem to have developed a strong tendency to expand Federal spending without providing the taxes to finance that spending. My second concern is that we have increasingly developed programs which incorporate automatic, usually accelerating, spending in future years, so that a larger and larger share of Federal expenditure is predetermined, out of the control of either the Congress or the Executive.

For the past three years, the Brookings Institution has been making and publishing detailed analyses of the Federal budget and its implications. In its most recent study entitled "Setting National Priorities: The 1973 Budget," its findings are that, given the present trends in Federal expenditures and the current tax structure, spending will outpace revenues until 1977, even with a full-employment economy. Addition of any major new programs or economic performance below this high level implies an even longer period of continuing deficits. Now any forecast of this sort cannot be precise, and this one was made before the recent additions to the current deficit were legislated, but the pattern it suggests is certainly accurate.

We, as a nation, are faced with choosing one of three paths:

1. We can permit the present trends to continue, accepting the inflation which is bound to result.

2. We can limit expenditures to fall within the resources we make available through taxes.

3. We can increase taxes to bring revenues in line with the costs of the programs we are initiating.

The present administration has indicated that its choice among these possible courses of action is the second, that we restrict our spending to what is possible with the resources arising from our present tax structure. As one step in this direction, they have requested that an absolute limit be placed on spending in the current fiscal year independent of the total of individual appropriation measures. If this is an absolute ceiling without the loopholes included in earlier ceilings, and if it endorses presidential flexibility to adjust allocation of funds between programs to meet the ceiling requirement, then it could be a reasonable first step toward bringing expenditures under overall control. But even that has only limited impact on the longer-range problem of the next several years, since it leaves untouched the trend toward legislation which creates uncontrollable future spending usually not balanced by offsetting revenues.

The recent expansion of Social Security is a good example of this kind of future commitment. Most of the publicity given this action focused on the 20 percent increase in benefits effective September 1. Some attention was given to the fact that the wage base for tax purposes has been scheduled to increase in both 1973 and 1974. Thus, some increase in tax income has been provided to partially offset the cost of the increase, but only about a third of the cost in these next two years. Furthermore, this increase in the wage base is, itself, a source of future costs, since, as the wage base is increased, the benefits to those retiring in future years will include consideration of that higher base. But even this is not the whole story. There is a much less well-known provision of the act which introduces an automatic escalator clause in both the amount of benefits and the wage base. Beginning in 1975, every year in which the consumer price index has gone up by three points or more since the date of the last adjustment, both benefits and the wage base are to be increased by a corresponding percentage. The tax rate itself is set constant. Each such escalation increases the gap between cost and revenue, and each increase in the wage base, in turn, carries more delayed benefit increases. This is a completely open commitment on future revenues as the law now stands.

If commitments against the future of this kind were small, they would not present a major problem. But in recent years, about 70 percent of total Federal spending goes for expenditures that were predetermined in this fashion by past legislation--and that percentage has been growing. This does not mean that the remaining 30 percent is not, in large measure, also predetermined expenditure. Much of it goes to meet the costs of existing programs and the general business of government, predetermined commitments even though the funds are appropriated yearly rather than by prior legislation.

If we are to adopt the President's proposal that we restrict spending over the next several years to the resources available from the present tax structure, it is essential that we get the entire appropriation process under better control. For, under these circumstances, the only source of funds for new programs will come from reducing or eliminating existing programs. Even if we adopt the course of increasing taxes to finance new programs, we will only be postponing the time when the same problem of loss of control will have to be faced. The present piecemeal approach to the appropriation process, in which each program is examined and funded separately, and in which total expenditure is whatever results from these individual actions, is just not amenable to control.

The Congress needs to take some action to regain control of its part of the budgeting process. A bipartisan resolution has recently been introduced in the House which would prevent consideration of any appropriation bill until an overall budget had been agreed to, both in terms of total size and in distribution by appropriation categories. Once this overall budget was set, any appropriation exceeding the budget allotment would require a two-thirds majority for passage. Such a step would certainly be a move in the right direction.

Many people who have studied this problem in the past, myself among them, have suggested that Congress should establish and staff a Joint Committee on the Budget to provide the Congress with an independent view of the whole budgetary picture and with the analytical capability now only available to the Executive Branch. Federal Reserve Chairman Burns, in recent testimony before the Joint Economic Committee, urged that Congress give careful consideration to this suggestion. Proposals to implement this plan are now before the Congress, but it seems unlikely that they will be acted on by this session.

In the absence of these or some other constraints on our willingness to spend without the accompanying taxation, we are certainly faced with the rekindling of the inflation which we have just spent three hard years bringing under control. The outlook for the economy in the latter part of 1973 and in several years to follow depends strongly on how we face up to this problem now. The seeds have been planted for a significant period of stable growth. How we handle the threat of renewed inflation will determine the yield at harvesttime.