Economic Policy Strategies for the 1970s

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During the past few weeks, our nation has experienced an unusual phenomenon--a new burst of public awareness. The prospects of gasless Sundays, slower highway speeds, reduced airline service, lower temperatures in homes and factories, and a less glittering Christmas have made everyone keenly aware of the "energy crisis." Seldom has public interest and concern with an economic issue developed so rapidly and so intensely. Suddenly everyone seems to understand that we have a problem. And, typical of American public behavior, some are spending all their time trying to identify the culpable parties. At the same time, others are demanding immediate corrective action as though the policy prescription were perfectly clear.

It has been unsettling to have this awareness thrust upon us. We are uncomfortable in being reminded that the shortage of energy has been evolving for some time and we are sobered by the thought that perhaps this is only part of a general natural resource scarcity which we have been warned could affect our economy's performance. Only a few years ago, this concern spawned a flood of apocalyptic writings on the crisis of resource scarcity and over-population. At the time, the interest in these problems and some of the related environmental issues seemed far less serious than they do today. Then, they appeared only to reflect a shift in preferences rather than an observed increase in the magnitude of the problem. It was even argued by some that the problems appeared to represent only what some writers have called "man's need to have a crusade." But now the problems seem to have escalated, to be more real, more important and more painful.

Certainly, no one questions that scarcities or shortages in the supply of raw materials and energy can, depending on their magnitude and the duration of their existence, have a significant negative impact on the economy's performance. And just as certainly, prospects of deterioration in performance will call forth policies to correct, contain or restrain the impacts of these shortages on both our short-term stability and long-term growth.

This evening I would like to focus my remarks on this issue of economic policies in a changed environment--an environment where supply factors make economic policy formulation and implementation an even more difficult challenge. I would like to share with you some of the kinds of considerations that go into making public policies--ideas that are frequently not widely discussed because they are so broad and abstract. The implications of scarcities or shortages for economic stabilization policies--and here I mean the use of both monetary and fiscal policies to achieve and maintain stable prices and relatively full employment--are not simply abstract, theoretical exercises of concern to economists and the armchair policymaker. It seems clear to me that shortages of supply serve to constrain our achievable economic goals at least in the short run and the public must be aware of those constraints if they, the public, are to give realistic direction to policy efforts, to have realistic expectations of the results that can be achieved and to make realistic assessments of economic policies and economic policymakers.

Unfortunately, public expectations of the performance of economic policies even in the absence of scarcities have been greater than those policies could be reasonably expected to achieve, attributable I am afraid to policymakers and economists who promised more than they could deliver. Since the 1930s, the government has been brought actively to the support of economic well-being, economic stability and economic growth. It has been believed that the "new economics" would solve our problems--all that was required was "good management." And we've had some success but also some failures over this period. To a substantial degree, the difficulty has been that our expectations both for the economy and for economic policy have been greater than our capability to deliver.

The basic emphasis of fiscal and monetary policy over the past few decades has been on the management of the demand for goods and services. Supply considerations have not been ignored, of course. We have, for example, affected supply through agricultural support programs and minimum wage legislation even though supply effects may not have been the primary or sole objective of these programs. We have also taken the existing limits of capacity growth into account in our planning. But the basic thrust and emphasis have been on influencing and affecting private and public demands for goods and services.

As everyone in this room is aware, efforts have been made to stimulate demand whenever we have had an underutilization of our human resources--less than full employment. On the top side of the cycle, in order to reduce the pressures on prices, policies have been directed to reducing demand whenever our resources are fully utilized.

In this direct if simplistic view of stabilization policy, it is assumed that full employment is possible without unacceptable price increases. This follows in turn from the assumption that the factors of production other than labor are idle or that we are capable of providing them very quickly. This means that no supply constraint or only a limited supply constraint is presumed to exist. As long as this is true, we can have some success through demand management policies in achieving full employment and stable prices.

The reasons for our lack of complete success in following this type of scenario highlight some of the difficulties that economic policy faces in a changed environment where supply constraints may exist to a serious degree. Clearly there have been a number of periods in our history in which we were unwilling or unable to restrain demands on our productive potential and inflation resulted. You will recall that in the early 1960s the economy was characterized by stable prices but an unemployment rate of about 5 1/2 percent. Demand was stimulated. Later in the decade, the demands of the Vietnam war, with heavy pressures on manpower and other productive resources, plus the initiation of vast new government social programs--demands not covered by commensurate tax increases--reduced the unemployment rate to 3 1/2 percent by 1969. At the same time, however, inflationary pressures mounted. These expansionary policies sowed the seeds of an inflationary cycle from which we have not by any means fully extricated ourselves. During this period, we simply asked too much from this economy in terms of both public and private goods. We did not heed our own estimates of capacity. Total supply could not adjust as rapidly as demands increased and price pressures resulted. This is another way of saying that <u>public expectations for the economy</u> exceeded its ability to deliver.

<u>Public expectations for economic policy</u> have also exceeded the capacity to deliver. Our recent inflationary experiences indicate this very clearly. As Chairman Burns has pointed out: "the severe rate of

inflation we have experienced in 1973 cannot possibly be attributed to monetary management or even to public policies more generally." The upsurge in prices this year reflects a variety of special influences. Some were demand oriented and affected to some extent by policy--such as the worldwide economic boom superimposed on the boom in the United States and at the same time the depreciation of the dollar in foreign exchange markets boosted prices of imported goods and added to overseas demands on our own productive resources. But the major influences were supply oriented. We encountered critical shortages of basic materials since much needed expansion in industrial capacity to produce these materials had not taken place. Crop failures in many countries restricted available supplies resulting in the rapid escalation of farm product prices. At the same time, shortages in the energy field caused fuel prices to spurt upward.

Even in the absence of unrealistic public expectations, these special factors would have made the formulation and implementation of economic stabilization policies difficult. And now we appear to be confronted with an even more difficult situation as we look ahead to possibly critical supply shortages.

If we are to focus more carefully on the policy difficulties we may encounter, we should clarify the magnitude of the supply problem. Obviously, if we are rapidly moving toward an environment in which our population growth and per capita resource demands exceed availability, we end up with the apocalyptic conclusion of "Doomsday." This I reject completely. Exhaustive studies by the Resources for the Future, among others, have shown that there is no foreseeable limitation on supplies of basic natural resources. Extreme pessimism is also unwarranted because it attaches insufficient weight to the impressive array of adaptive mechanisms through which a market economy such as ours responds to shifting patterns of resource scarcity. Technological change and changes in relative prices are powerful mechanisms. Our proven adaptability is a basic strength. Many of you may remember the forecasts of the 1930s and 1940s that our economy was stagnating--that economic growth was no longer possible or likely. But our economic growth was phenomenal. The current situation should not lead us into again making the same forecasting error.

I do not mean to play down the short-run adjustment problem we face. But even in the short run the price mechanism can and does work. With limited supplies, price signals will activate the adjustment mechanism.

Even if we were confident that we could adjust to supply constraints we still haven't eliminated the difficulties for economic policy or our expectations of what these policies can deliver. First, the adjustment takes time. It is not instantaneous. Thus, we can argue that in the presence of shortages of supply, policies designed to expand total output and perhaps increase employment through demand management may work more slowly than they would without supply constraints. Second, the process of adjusting supplies upward will, in a market economy, require increases in prices. It is the price mechanism that communicates the demands for increased capacity, raw materials or new technologies.

There is an implication in this that economic policies in the coming years might profitably focus on steps to improve the adaptive mechanism--steps to smooth out or speed up the short-run adjustment and reduce the price pressures necessary to activate adjustments by making appropriate institutional changes. Further, established policies and programs should be reviewed for indications of costly supply restrictions and new problems considered for stimulating supply directly. Nor should we ignore other new programs designed for other purposes. The costs in terms of the effects on supplies should be explicitly considered in our cost-benefit calculations.

Even with improvements in the speed of adjustment, it will, I fear, be difficult to achieve both of our goals of full employment and price stability simultaneously. It may even be impossible if we insist on defining our short-run goals too restrictively--say 4 percent unemployment and 2 percent inflation. In the presence of non-human resource scarcities, we may not always be able to achieve full employment before generating price pressures on our other resources. Adaptation may simply not be that rapid. So indeed, this puts heavy pressure on economic policy formulation and implementation--especially so if we are as a nation unwilling or incapable of making what has been called the cruel choice between increasing unemployment and increasing inflation.

Even if the "cruel choice" is made, there are problems for policy in a resource-constrained environment in which supplies adjust slowly. The process of achieving the goal of minimum unemployment could put us in a future position where not only is the goal of price stability outside its range of tolerance but also where it is impossible to continue to achieve acceptable rates of unemployment. The objective of economic policy controls cannot be simply to get us from where we are to where we would like to be. The optimal policy is one that brings the economy to a desired point in the "best way." The economy is dynamic. Policy actions set in motion a whole train of events that if not carefully watched can bring us to a state beyond the targeted point that is untenable.

All this means simply that our policies must be conceived within a broader time frame than in the past. The short run merges much more rapidly into the long run when adaptions to--and adaptions of--supply shortages take time. Our short-run successes of economic policy may not look as good as they have in the past, but over a longer time frame perhaps they will be closer to what we really want.

What then are the appropriate policy considerations for the 1970s? What are the alternative strategies in a changing environment? I am certain that for some of you what I have said so far is terribly abstract. For others the outline presented is naive and simplistic. I would agree with both groups. I do not pretend to have the policy answers completely and clearly identified. Most of these views will require further evaluation. But I do feel that these ideas, sketchy at best, give us some direction for the road ahead, some indication of where the road blocks and rough roads may lie for policy and for the public's expectations of our economy's performance.

Of greatest concern to me is the point I made earlier, that is, the tendency for public expectations to outrun realities in the economic sphere. This isn't a new problem, but with shortages--even though correctable or adjustable over time--it takes on added seriousness for economic policy. If we fail to recognize that available economic resources form a constraint upon national abilities to achieve our goals, the gap between expectations and realities will widen. It isn't necessary to write a whole scenario before it becomes clear that the wider the gap, the greater the public concern, the greater the demands for action, and the greater the likelihood of ineffectual or inappropriate economic policies.

This does not mean that any of us are opposed to an improved quality of life or that we must revert to an "anti-environmentalist" stance. But it does mean the realization that decisions to produce public benefits impose costs. We need to weigh these costs and benefits not only for the particular program under consideration but also against all of the other programs with benefits and real resource costs. In terms of public policy, this suggests the need for Congressional budgetary reform, especially in putting an end to fragmented consideration of expenditures and by relating expenditures to prospective revenues and the nation's needs. It is essential that Congressional responsibility for resource allocation be performed with the same emphasis on the total outcome which is given to the preparation of the budget by the Executive branch.

One additional point peripheral to the dangers of excessive expectations, but related in the sense it concerns an increasing but important constraint on resources, is the rapidity of economic growth throughout the world. Resource needs have grown rapidly as standards of living in industrialized nations abroad have approached ours. Too little has been noted of the possible effects of this growing pressure of demands. Obviously, foreign economies have and will be increasingly competitive in the world resource markets, including our own. No longer can we view resources as virtually unlimited. This element too will force us to constrain our expectations.

Returning again to my earlier discussion, we might also tote up some of the changes that may be necessary in the public's expectations of economic policy performance. The old goal choice or trade-off between unemployment and price stability still exists, but in a world of even short-run shortages, new difficulties are added. As noted earlier, economic stabilization policies may well have to be formulated and implemented with a view to a longer time frame. We will have to look more carefully beyond the short-run effects that we can achieve to the longer-run conditions we may create. More flexible fiscal policies may be a part of the answer, as would appear to be policies and programs to smooth out or shorten the time necessary to make adjustments. But I would be misleading you and contributing to excessive expectations of policymakers' abilities if I suggested that we have all--or even most of--the answers. Our knowledge of control procedures for this type of environment is still limited but it is growing.

Clearly, humility and cautiousness must characterize our approach to economic stabilization. Given the dynamic nature of our economic system, we must proceed like a physician. He makes an initial diagnosis and prescribes a treatment. Since there is a possibility that the initial diagnosis is incorrect, or that the prescription produces undesirable side effects, he arranges for some monitoring to check up on his diagnosis and treatment. If the patient doesn't respond as the prognosis suggests, he changes the treatment. Our economic stabilization controls must follow a similar pattern.

To stretch the analogy somewhat, the physician's difficulties arise when the patient's wife becomes upset because the physician's efforts to not bring immediate success (excessive expectations), she evaluates the physician as being incompetent and prescribes her own home remedy, with possibly serious results. We must guard against encouraging more than our policies can deliver, but we must also clearly identify what we think we can reasonably deliver to warrant reasonable public patience in achieving the goals.

It has been said that politicians and intellectuals are traditional "viewers with alarm." Any other attitude would compromise their reputation. They consider it their duty to decry gaps between the performance of the economy and its potential. If they didn't, their colleagues would believe they had sold out or had lost their critical faculties.

The current and short-run prospects of our economy are a matter of concern but not of alarm. And I say this feeling strongly that I haven't sold out or lost my critical faculties. The economy can and will adjust to the developing environment of relative shortages. It was in the process of doing so before the recent burst of public awareness. And based on my earlier experience in fiscal policy and now my experiences in monetary policy, I know that although it will be a difficult challenge we have the capability of meeting it.

America is the strongest of all nations--in our productive capabilities (agricultural as well as industrial), in our natural resources, in our steadfast belief in our democratic form of government (despite recurring frustrations and credibility gaps) and in the indominable spirit of our people. Let us not lose that perspective as we worry through the problems of today.