Our Turbulent Economy

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The current state of the U. S. economy presents a picture of cross currents, variety--and indeed tumult unknown in our recent history. Anyone glancing only at the overall Gross National Product data for the first quarter would have to conclude that it had all the earmarks of a recession period. Indeed, some economists view it just that way. Yet during the same time that total real output dropped at an annual rate of almost six percent, more sharply than any time since 1958, many of our major industries were operating at or near capacity. While the overall number of unemployed was rising nearly ten percent we had major industries operating below capacity because they could not hire the skilled labor they needed. And despite this overall decline in output, materials and intermediate products of every sort were in short supply, with producers allocating their output to customers.

Not only did the most recent quarterly period show a decline in real output, but the growth during the three previous quarters was significantly below the long term growth trend. Yet the upward movement of prices at an annual rate of over 10 percent--was the greatest since 1951. The amount of slowdown which occurred would normally be expected to be accompanied by declining growth in borrowing and lower interest rates. Instead we are seeing new records set in short-term rates. We see long-term rates pressing against record levels. If this is a recession it is indeed the strangest one the economy has ever undergone.

As early as a year ago, when data relating to the first quarter of 1973 became available, it was clear that the economy could not continue the extremely high rate of growth that was then in progress. A gradual slowing through the balance of 1973 and, possibly early 1974, was generally expected, with a return to about a so-called "normal" rate of four percent in the latter half of 1974. Accompanying this slowdown, a slowing of the inflation rate was also logically expected. Given conditions at the time, these were reasonable expectations. And, indeed, second and third quarter output did show the expected slowdown. But there was little evidence of any slowing of the inflation rate, primarily because of the intense world-wide demand for food, but also because of high levels of demand for a wide range of other commodities. Then came the October War and the Arab oil embargo. No one needed to be an economist or even to read the newspapers to discover the impact of that action on his daily life. Each of you, I'm sure, has his own private horror story to tell about the new sport that suddenly became the new national pasttime--filling the gas tank. The embargo is now behind us, even though the energy problem is not. And we have to learn to live with the increased price of energy. The new price level for gasoline is not the only consequence. Higher petroleum prices are seeping pervasively through the economy to raise the cost of producing virtually everything we use from toothpicks to computers. The increase in energy costs was, in large measure, responsible for the unpredicted acceleration of the general price level both in late 1973 and early 1974.

But the impact of the oil embargo was not limited to prices. It had a serious impact on industrial output as well, not the least of which was the direct production cut in petroleum products themselves--plus the cutbacks in growth of electric power production and natural gas consumption which came for conservation measures. Automobile sales, which had been declining gently from the unprecedented levels of the first quarter of 1973, tumbled drastically, and production was cut even more severely to prevent enormous inventory gluts from developing. The recreational vehicle industry virtually closed down. Hotels, resorts, and other businesses dependent on the auto vacation traveler felt the pinch, and airlines were forced by fuel shortages and fuel costs to curtail service. In short, a significant portion of the decline in output during the past two quarters can be ascribed to the oil embargo and to the impact of higher oil prices that prevail now that it has ended.

At the same time that the embargo was making us all aware that we were rapidly outgrowing all our sources of energy and causing a slowdown in several industries, it was also acting in an expansionary direction, providing incentives for the coal industry, accelerated work on nuclear power plants, and for rail transportation, to mention a few. Domestic oil exploration activity is at a level not seen since the early 1950's. These expansion needs added strongly to a demand for capital goods that was already underway as a result of the strong pressures on capacity, the need for modernization, and the requirements to meet environmental and safety regulations which had been underway for several quarters. Even the depressed auto industry began making major capital investments to meet what is generally viewed as a permanent shift in consumer demand toward smaller and more efficient cars and to meet the pollution control requirements which become much more stringent beginning with the 1975 model year.

Thus we find ourselves in a very strange economic environment in the spring of 1974. While all recent surveys of consumer attitudes have been very pessimistic in tone, the consumer is spending his money. Consumer spending has been growing nearly twice as fast as the growth in disposable income. But the consumer has been enjoying it less. While spending is up, the real level of goods and services that this spending purchased is down slightly, and one place the consumer is not spending his money is for new housing. There has been no decline in the basic demand for new housing, but high interest rates, the decline in personal savings, and the shifting of savings from normal channels into areas yielding markedly higher returns have sharply curtailed the availability of mortgages. If we were in the midst of a typical recession, this decline in real consumer spending would be accompanied by a slowdown in capital spending, but instead we are currently witnessing accelerated capital spending and appropriations, combined with fairly rapid returns to more normal conditions in many areas affected by the petroleum embargo and a slight decline in the unemployment rate. In addition, we are on the threshhold of what promises, weather permitting, to be a record year in agricultural output. It seems to me that two things are holding back the resumption of rapid economic growth--inflation and capacity limitations.

The outlook for reduction in the rapid rate of inflation which is currently occurring is dim in the immediate future. The full impact of increased energy costs has yet to work its way through the price system to the final sales level. We are just at the beginning of a long period of labor negotiations in which settlements are bound to include "catch-up" provisions that will add further to costs. Despite the promise of a bumper U. S. harvest, world food stocks are low, so that demand will put a floor under agricultural prices. At the same time energy and fertilizer costs will increase the costs of producing our food. Under the best of circumstances it seems likely that several quarters will elapse before the rate of inflation recedes to a level on the high side of what were our goals only two years ago.

Just as it is going to take substantial time to subdue inflation, so an extended period of capital expansion is needed to add production capacity in those industries that are most short of capacity. Production of almost every important raw material used to feed our industrial machine, from paper to steel, must be expanded if substantial economic growth is to resume. Massive additions have to be made to our coal, petroleum, and electric industries, particularly if we are to move toward energy self-sufficiency. Even in industries where capacity is adequate to permit growth, capital investment is required to meet environmental problems, to comply with the occupational health and safety regulations, and to increase productivity as an antidote to rising costs of energy, materials and labor.

The outlook, then, for the next few quarters, has got to be one of slower growth of the economy than the four percent or so annual growth we have come to consider normal, with the capital investment sector (except housing) significantly stronger than the consumer area. This sluggishness is likely to be accompanied by levels of unemployment somewhat above those we have customarily set as our national objective in the post war period than we would like to see. The reward for going through this pain, a slowdown in the general rise in the price level, is going to be slow in coming. This means that considerable political pressure is going to build up for stimulative fiscal and monetary policy. Already we have heard several calls from leading political figures for a major tax cut to stimulate consumer spending and employment. Yet, it is easy to make the case that virtually all the first quarter drop in output and increase in unemployment resulted from the cutback in the auto and petroleum related industries. We will probably not know where the economy is heading over the longer term until the second quarter's data are available. Given the special circumstances of the last six months it seems very unlikely that we are in a recession in any normal sense of that word. Policies appropriate to bringing about rapid recovery in a more typical business slowdown could easily bring on substantially worse inflation that we are now experiencing without significantly increasing real growth. This brings me, then, to the question of appropriate economic policy for the next several months.

The current situation presents a formidable challenge to economic policy. With the economy exhibiting sharply rising prices and, at the same time, declining real output, there is more than the usual amount of uncertainty concerning the underlying state of total demand relative to total capacity.

For purposes of framing economic policy, we must start with the critical factors involved in the current situation and the possible remedial steps that might be taken to improve that situation. But, it is also important to review how we got to this unenviable position in order to avoid repeating past errors.

Following the economic downturn of 1969-70, monetary policy in my opinion was not excessively expansive. But, the growth in monetary aggregates during 1972 and the first part of 1973 was higher than warranted by subsequent economic developments, and higher than desired by the Federal Reserve. Given the lagged effects of monetary expansion on aggregate economic activity, and the fact that the economy was fast approaching capacity output in the latter part of 1972, this unintentional expansion of the aggregates most likely added to inflationary pressures.

Nevertheless, other factors share even more importantly the responsibility for the current inflation problem. Fiscal policy, in terms of budget deficits, has been excessively expansionary in recent years. Providing for the financing of the deficits is one reason for the monetary expansion we have witnessed. The revision of the international monetary system--a revision which entailed successive devaluations of the dollar--is another factor. This factor, coupled with simultaneous strong economic expansion of industrialized nations abroad led to sharper export demand for United States goods than envisioned. In addition crop failures abroad led to larger demands for United States agricultural output than foreseen, resulting in sharp increases in domestic food costs. Finally, of course, the oil embargo, coming at a time when United States import demands for petroleum products were rising sharply, resulted in absolute shortages of petroleum based products and sharp increases in prices for such products in a very short period.

I would also add my personal opinion that the wage-price control program which was just buried was kept alive too long, given monetary and fiscal policy actions over the period. This had the unfortunate damaging effect of masking inflationary pressures. It caused distortions in relative wages, prices and output, and it made accurate economic intelligence increasingly difficult to acquire.

Taking a slightly longer term view, the quickening in the pace of inflation following 1967 has brought into sharp relief a serious problem associated with the Employment Act of 1946 goal of fostering full employment of resources. While it is true that public policy also attempts to achieve relatively stable general prices, the latter goal has been subordinate to the employment goal for a number of years.

It appears to me that some labor unions and some corporations have come to act increasingly on the assumption that increased wages and increased costs can be passed through to final product prices almost with impunity. Given the commitment to full employment, unwarranted increased in prices and wages--unwarranted in the sense of maintaining employment levels given demand and productivity conditions--have tended to be underwritten by government policy in order to avoid unemployment. Resulting general price increases renew the cycle. It seems clear that this pointless circle of wage-cost-price inflation must be brought under control without denying a role for collective bargaining and for market pricing which allows for relative price changes and possible income share changes as economic conditions change through time. A permanent price-wage review board with principally a public reporting responsibility, coupled with some adjustment in the weights attached to employment and inflation is one possible means of approaching the problem short of direct controls.

However, this problem and the problem of closer and more appropriate coordination of longer run monetary and fiscal policies are matters that will be grappled with in future periods. The pressing question now is what policy actions should be taken in the current adverse situation. Several factors must be considered here, and they lead me to a conclusion regarding short term policy that some may view as an unacceptable position.

I believe we must recognize that the current situation differs substantially from anything we have experienced in recent economic history. Aggregate supply and international considerations must be taken into account more explicitly than they have been in the past. And, we must recognize that rising energy costs represent a loss of wealth or real income in favor of other nations. The extent of these real income losses is by no means clear at this juncture, nor is it clear how the oil producing nations will employ the wealth transfers they are now receiving. Finally, we have just seen the end of a protracted period of price-wage controls, and the results of removing those controls are not yet certain.

As indicated earlier the first quarter economic data indicate that the real output decline we suffered is concentrated so far in a few sectors most affected by the energy problems and most sensitive to high interest rates. Unlike other periods of decline in real output, the overall investment picture for the economy appears to exhibit sustained demand strength thus far. Financial market demands remain strong. And, real consumer spending, while not buoyant, does not show pronounced weakness, and, unemployment, after increasing sharply has, in the short run, been declining marginally.

In the face of these conflicting signals concerning the state of the economy, policy proposals and recommendations diverge more sharply than usual. One group advocates sharp restraint in general monetary and fiscal policy to reduce inflationary pressures, with the resulting unemployment and specific industry effects to be dealt with by appropriate special programs. Special programs, I might add, the dimensions and form of which are not at all clear, let alone in place.

Another group believes the underlying demand situation is weak or borders on weakness. For that reason, expansive or at least accommodative policies are advocated to maintain employment and encourage investment spending. It is argued that most of the very sharp price increases we experienced last year and this year are attributable to non-recurring special factors. If so, with inflation expected to subside somewhat later in the year, a sharply restrictive monetary policy would only exacerbate the process of rising unemployment already started. Tax relief is advocated by some to restore some of the lost real income in the lower and middle income brackets and as an incentive to organized labor not to seek a restoration of real income by means of increased nominal wages.

Under such uncertain circumstances and conflicting proposals, I should like to counsel caution in setting economic policy in the short term. If underlying aggregate demand is strong, an expansive policy would simply worsen the inflationary situation, given supply constraints attributable to energy problems and deficient investment in recent years. If underlying demand is weakening, a sharply restrictive policy would result in an unacceptable unemployment rate that would elevate pressures for a fast reversal of policy--a process we have seen enough of in recent years.

On balance, I conclude that moderate monetary restriction is called for under present circumstances. I take the position that inflation attributable both to special factors and more generalized pressures requires restraint even though that might entail some small increase in the unemployment rate for a year or so at least. But I would be reluctant to see the unemployment rate rise substantially. Although I am in sympathy with the desires of those who wish to stimulate the economy by expansive fiscal policy, as yet I see no indication that the tax cut proposal would in fact lead to restraint on the wage side. Without such restraint an expansive policy would, in my opinion, only foster a more severe inflationary situation. My position is not doctrinaire, however. I am willing to revise my opinion if a viable means of confronting the problem of so-called stagflation can be demonstrated and stands a good chance of being carried through in all of its facets.

In the absence of such a demonstration currently, I believe it important that we recognize that our current inflationary problem cannot be resolved quickly at reasonable cost. The problem has built up over a long period. It will take a long period to resolve it. Precipitous attempts to solve the problem would only result in the imposition of social costs that would, in my opinion, be disproportionate to the social benefits received. More than anything, we must now have patience in order to help establish a sound basis for sustained economic growth at more reasonable rates of price increases in 1975 and the years ahead.