The Economy--Another Testing Period

Remarks of Mr. Robert P. Mayo
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The American economy has been subjected to a series of buffetings since World War II that have tested its ability to resist many shocks--shocks that could have touched off cumulative declines in general activity. Each of these tests has been met in a fashion that has gratified most of us who are familiar with the history of the 1930's and earlier periods.

The most recent buffeting of the economy occurred with the five-month Arab oil embargo and its aftermath. The embargo, which had not been foreseen, greatly worsened an already stringent fuel situation. There were a number of consequences. Existing downtrends in two of our most basic industries, autos and housing, were accelerated. Petroleum refining declined sharply. Output of products based on oil, all in strong demand, was curtailed--especially plastics, man-made fibers, and fertilizer. Sales of recreational vehicles plummeted. Tourism, of vital concern to many areas, was hard hit. Because of these developments, total output of goods and services--"real" GNP--declined in the first quarter, sharply by the standards of the past quarter-century.

But despite widespread fears, the declines in activity associated with the oil shortage did not accelerate. Throughout this period the capital spending boom, underway for more than a year, was fully sustained. In fact, demand for new plant and equipment spending gathered strength, on balance, because of programs to conserve energy to develop new energy sources and to expand existing sources. To cite only one sector, oil and gas well drilling is now at its highest rate since the 1950's. And

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it might even have been stronger were it not for the fact that exploration activity has been limited by availability of supplies and equipment. Incidentally, extensive drilling operations are in progress in Illinois and Michigan, so these two states may play a larger role in oil production in the years to come.

Demand for capital goods of virtually all types is intense--perhaps to an unprecedented degree. New orders continue to outrun rising output. Shortages of materials, components, plant capacity, and trained manpower have prevented even larger increases in output.

While the strength in demand for producer goods is almost universal, the picture is particularly vigorous for farm equipment, heavy construction equipment, large trucks, railroad freight cars, overhead cranes for factories and utilities, and electrical generating and transmission equipment. Many manufacturers of such equipment have had to control acceptance of new orders and allocate supplies to dealers to assure the most efficient distribution of new output. Various firms have indicated that their order books are closed for 1974, even for early 1975. The powerful momentum of plant and equipment expenditure programs does not square with classical descriptions of a "recession" to say nothing of a "depression".

Partly because of demands for equipment and heavy construction the steel industry, of great importance in this region, is operating at full capacity despite reduced demand from the motor vehicle industry, often its best customer. The most basic material, steel, heads the list of items in short supply for many purchasing agents. In the face of continued strong demand, steel output is almost certain to decline in the summer because of vacations and needed maintenance.

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While business spending on plant and equipment has continued to rise, consumers also have been spending at a rapid pace. Some merchants have been pleasantly surprised at the level of their sales in the past several months in the face of consumer surveys which indicated a loss of confidence and widespread pessimism. In the first quarter, personal consumption expenditures were at an annual rate of $845 billion, up 8.4 percent from a year earlier, despite declines in sales of autos and curtailed outlays in various other sectors. The year-to-year rise in consumption spending was only moderately below the 9.3 percent rise in disposable personal income.

Sales of retail stores in the first quarter were up only 5 percent from the same period of 1973. But results vary from sector to sector. Sales of the automotive group were <u>down</u> 15 percent in the first quarter, while sales of all other stores combined were <u>up</u> 10 percent. Moreover, preliminary data for April show retail sales up 8 percent, with autos down 9 percent and all other stores combined up 12 percent. A substantial portion, but by no means all, of this rise represents higher prices. Average prices charged at retail stores are not up as much as the Consumer Price Index because of the heavy weight for food in the CPI.

The data do not indicate that the American consumer's evident pessimism has significantly affected his purchases. Recent months have seen a sharp revival in sales of recreational vehicles which had been at very low ebb during the oil shortage. (Whatever one may think of motor homes and other recreational vehicles, they are hardly necessities). Tourism has also revived, and the director of the Federal Energy Office recently told the public that they should go ahead with normal

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vacation plans--hopefully at no more than 55 miles per hour. It is in many ways unfortunate that the public's concern with fuel shortages has faded so rapidly.

Sales of large cars have strengthened in the past month or two and small cars are now much more available. Nevertheless, total auto sales have continued at a sluggish pace in April and early May. Perhaps the fuel shortage had masked a reduction in the overall demand for cars which followed two years of very high sales.

The housing industry continues to be seriously depressed. An apparent incipient upturn in output and sales of homes and apartments earlier in the year has been undercut by sharp increases in short-term interest rates and associated outflows of funds from thrift institutions. The impressive network of machinery built up over the years to shield the housing industry from the effect of rising interest rates have proved, once again, to be inadequate. Recently the Administration has offered proposals to channel additional funds to residential mortgages through subsidization of interest costs.

But the present vigorous economic picture continues to be marred by rapid inflation and concern that economic policies necessary to curb inflation will take the bloom off the rose. Prices have risen ten percent in the past year as measured by the Consumer Price Index. About three-fourths of this "two-digit" inflation is estimated to reflect the sharp run-up in prices of food and fuel. Increases in these sectors probably will moderate. Farmers' plantings of expanded acreage in the Corn Belt are far ahead, not only of last year's slow start, but also well ahead of normal. High farm prices have always brought forth a massive response in increased output by American farmers, and this ap-

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pears to be happening in 1974. And with increased fuel supplies, the worst of the rise in oil prices is probably behind us. Recently, one oil company reduced its retail price for gasoline "for competitive reasons".

Prices of many manufactured goods and services have been rising at a faster pace since the gradual relaxation and subsequent removal of official wage-price ceilings. Increases for many of these items are essential if products are to continue to be available, because rising costs must be recovered. But as in the case of agriculture, higher prices will bring forth increased output, and some prices may ease after the initial surge. One benefit of the end of general price and wage controls (petroleum prices continue under control) will be the elimination, to a large extent at least, of gray markets and other market distortions that grew up during the period when prices were not free to ration scarce supplies.

Even though there is reason to expect some moderation from the rates of price increase in the first quarter, under the best of circumstances it seems likely that several quarters will elapse before the rate of inflation recedes to a level considerably above what our goals were only two years ago.

And, 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

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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 to be one of slower growth in 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 postwar period. The reward for going through this pain, a slowdown in the general rise in the price level, is going to be slow in coming.

The current situation then presents a formidable challenge to economic policy. With an expectation of moderating but still rapidly rising prices and slower than normal rates of growth in real output, there is, at the same time, more than the usual amount of uncertainty concerning the underlying state of total demand relative to total capacity. And as a result of these conflicting signals, 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.

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

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increases we experienced last year that this year are attributable to nonrecurring special factors. If so, with inflation expected to subside somewhat later in the year, those supporting this view would argue that 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.

In order to assess these alternative courses we must review how we got to this unenviable position in order to avoid repeating past errors. One of the factors accounting for our current position was that 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. Even if we set our targets right, we can't always hit them, since we influence only part of the financial universe. 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 monetary 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 too 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

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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. Inflation, moreover, is worldwide.

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 organizations 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 increases in prices and wages--unwarranted in the sense of

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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 changes in income shares as economic conditions evolve through time.

However, this problem and the problem of closer and more appropriate coordination of monetary and fiscal policies are matters that will be grappled with in our longer run planning. The pressing question now in mid-May 1974 is what policy actions should be taken in the current adverse situation. Several factors must be considered here.

As I have indicated, I believe 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.

Under such uncertain circumstances, I should like to counsel caution in setting economic policies in the short term. If underlying aggregate demand is strong, fiscal and monetary expansive policies would

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simply worsen the inflationary situation, given supply constraints attributable to energy problems and deficient investment in recent years. If underlying demand is weakening, sharply restrictive policies 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.

I take the position that inflation attributable both to special factors and more generalized pressures requires moderate monetary restraint even though that might entail some small increase in the unemployment rate. But I would be reluctant to see the unemployment rate rise substantially. I am in sympathy with the desires of those who wish to stimulate the economy by expansive fiscal policy. Yet I see no indication that a tax cut would in fact lead to greater restraint on the wage side. Without such restraint an expansive policy would, in my opinion, only foster a more severe inflationary situation.

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.

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