Economic Prospects and Prescriptions

Remarks of Mr. Robert P. Mayo, President
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before the
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I am pleased to have been asked to talk to the Annual Tax Clinic of the Wisconsin Institute of CPAs. I feel at home with accountants since I had an accounting major in college--although I confess to not having gone through the rigors of a CPA exam. But, I also have more than a passing acquaintance with taxes. The mere mention of the word dredges up a host of recollections on tax problems during my years at the Washington State Tax Commission, the U. S. Treasury, as staff director of President Johnson's Commission on Budget Concepts, and as U. S. Budget Director.

But recollection is not my reason for being here today. While I won't ignore the opportunity to say a word or two about President Ford's tax proposals and other fiscal policy recommendations, I plan to take a little broader look at current economic issues and prospects and the possible public policy prescriptions for our economic difficulties.

It is hard to remember a period when so much radio and television time and press space have been devoted to the current state of the economy and the outlook for the next year. Virtually every opinion has been expressed by virtually everyone who has any credentials as an expert--plus some with no credentials at all. We have heard everything from the position that we are on the brink of a worldwide 1930 type depression to judgments that we have experienced only a minor setback in growth. Even the recent White House summit conferences

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were more notable for the broad range of views expressed than for a consensus on either diagnosis or treatment. There did appear to be a consensus on certain basic facts however. We are experiencing inflation of record magnitude and duration. Certain sectors of the economy--like housing--have undergone severe declines. The energy shortage is not going to disappear. But there wasn't much common ground on policy prescriptions, not even among the professional economists.

Nevertheless, I think the whole sequence of conferences did serve a useful purpose. First, I think they succeeded in making clear that even though the economy faces major problems, we are not about to have a major depression. Second, I think they succeeded in educating the American public to the fact that there are no miracle drugs that can cure our ailments overnight. Third, I think they made evident the vast array of special interest and special needs of various sectors of the economy which must be dealt with in arriving at solutions. And finally, I think that not only was there a general recognition that the steps which need to be taken are going to require effort and sacrifice, but also that the burden has to be distributed as fairly as possible.

I am not going to give you today a new set of prescriptions for our economic malaise. The monetary and fiscal policy tools referred to, sometimes derisively, as the "Old-Time Religion" at the recent series of conferences on the economy are "still good enough for me." They are still the major and most important tools available that are truly capable of having real impact on prices and economic growth. So many seem to be frantically searching for other simpler and easier answers. There aren't any.

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The current economic situation is extremely mixed. It clearly poses some very difficult public policy problems. Total activity has dropped substantially since the broad boom of early 1973. The drop was particularly significant in the first quarter of this year when real output declined at an annual rate of over 7 percent. It is virtually impossible, however, to sort out how much of that decline resulted from the oil embargo directly, how much from its indirect effects, and how much from the impact of anti-inflation policy. And as we know from the more recent data on total output, real activity has continued to decline on into the second and third quarters although the data after allowance for inflation have a wider margin of error than size of the reported decline itself. The data thus far certainly do not suggest a deep trough. Real output as measured by constant dollar GNP averaged over the first nine months of this year was only 1½ percent below the 1973 average level--the most productive year in our history.

Some sectors of the economy, especially in basic materials such as steel, remain strong. But one of the areas earlier experiencing boom conditions--capital goods--now appears to be softening slightly around the edges. Certainly, activity in the machine and capital goods industry remains vigorous, but less so as delivery extensions and new order softening begin to eat away at the tremendous backlogs created earlier.

But some of the consumer goods areas are showing less vigor. Retail sales after price adjustments have been flat to declining. Domestic auto sales declined steadily throughout 1973, and, while there was a slowly improving trend through September of this year, sales levels remain well below industry's average levels throughout 1972 and

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1973. October sales have dropped to ten-year lows, and there are some fears that the sharp price increases for the 1975 models, following on earlier increases at the end of controls, have aborted this slow recovery. Household durables, furniture as well as appliances, are industries which tend to follow the trends in housing starts by six to nine months, and both of these industries are showing signs of slowing down.

The most severely affected industry is, of course, housing. It is an industry in serious trouble. New starts are running at less than half the record level they reached a little more than a year ago.

On the heels of these developments and increasing numbers of announcements of layoffs, the unemployment rate is receiving increased attention. However, the evidence would seem to suggest that the situation is significantly less severe than the alarmists would have us believe. No one likes to see any increase in unemployment, but the amount of the increase thus far is significantly lower than had generally been predicted by most economists around the beginning of the year. From a rate of 4.6 percent of the work force in October 1973, the lowest level since March of 1970, the rate has risen to 5.8 percent in September. But during this same period, the total number employed has, nevertheless, climbed by almost 1 million, and payroll employment has grown by 800 thousand. As is the case with output, the labor figures indicate a distinct slowdown but certainly are not at levels one would expect to see in a sharp recession.

The economic fact which has, I believe, led to the greatest concern, is the pervasive influence of inflation. Since the mid-1960s, the rate of price advances in each succeeding year has been larger than the preceeding year except for 1971 and 1972, when price and wage controls had their greatest effect. In the last year or so, the pent-up price

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pressures, which had been restrained by controls, have been combined with the sharp increase in energy prices resulting from the oil embargo, the subsequent cartel setting of oil prices, and strong world market demands for our farm products to push our rate of price increase in the first three quarters of this year into the double digit range, an 11 percent annual rate. Even if we assume, as several have suggested, that only a quarter of this increase comes from these unusual pressures, the increase would be at a rate of over 8 percent a year. It is this acceleration in the inflation rate, rather than the slowing in business activity, which has created the atmosphere of uncertainty and pessimism for consumers and the business community alike.

What then is the outlook for the months ahead? It would be pleasant to forecast a rapid decline in the inflation rate and a sharp upswing in business activity. But I see little chance for such fortuitous events. On the other hand, I also see little chance of a sharp worsening of conditions. Two potential events on the horizon could severely affect the economy. One is the possibility of renewed fighting in the Middle East and a new oil embargo. The other is a prolonged strike in the coal industry. Barring the occurrence of either of these events, the outlook for the next several months is for little or no economic growth and a slow decline of the inflation rate. There may be minor setbacks along the way but I think this general course has already been determined by the monetary and fiscal policies of the past several months. The major impact of the energy and agricultural price jumps hopefully have completed most of the effect they will have on price levels. After the coal negotiations, the labor calendar is relatively light, so that wage pressures should be less severe than they otherwise might be. The general slowing of business and the decline in many nonagricultural raw material prices

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are beginning to ease the need for inventory financing, taking pressure off the short-term money markets, so we have to see some softening in short-term rates. The preliminary third-quarter data shows a sharp slowing in the rate of accumulation of inventories. If these trends continue well into 1975, funds should begin to flow back into the mortgage market and initiate a revival of the housing industry by a year from now. Consumer spending should also return to levels which will stimulate rather than merely sustain the economy as the specter of continued severe inflation gradually recedes.

For these trends to continue, building toward recovery at declining inflation rates, continued restraint is required by all of us for some time to come. The keys, it seems to me, still reside in monetary and fiscal policy. I am well aware that there are broad disagreements on how these tools should be used, on the appropriate mix, and the appropriate balance of control via taxes versus control by spending level and distribution. But no proposals emerge for other policy actions which could really deal with the problem in its overall aspects. All of the other suggestions which received significant support and which were incorporated in the President's program were acknowledged to be of secondary impact, whether for increased antitrust enforcement, wage and price monitoring, simplification of regulatory procedures, or conservation.

I have been somewhat dismayed by the reception that the President's proposals have received. While there is certainly room for honest disagreement on specifics, the attitude I find disturbing is that "the President doesn't really have a vigorous program." When I question these critics as to what they would propose as a vigorous, new, exciting attack on the problem, they come up empty-handed. They keep saying "all we want is leadership," which is obvious, but not very helpful.

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This is, I submit, another case of wishing for a simple answer when there isn't one.

As you know, the President's program has a number of elements. It includes what I like to call programs with long-range impact. Here I would include the whole group of recommendations dealing with the energy situation, from increased research on new energy sources to improved gasoline mileage. These are aimed at avoiding a repetition of the oil embargo situation and, to the extent they lead to lower energy costs, will eventually have some impact on the price structure. Similarly, improved and extended antitrust legislation and enforcement can affect the overall price structure over an extended period of time.

The programs designed for intermediate range impact cover primarily the food and housing areas. In food, it will take one or two good crop years to bring grain supplies up to more adequate levels in terms of rapidly growing foreign needs and for the effect of these higher levels to work their way through the livestock cycle. In housing, the intermediate time horizon of the programs would seem appropriate too. The extra 100,000 housing starts will help but obviously aren't large, considering the decline that has occurred. And gradual additions to the pool of mortgage funds needed to increase sales of new homes will develop slowly.

And finally, we have the short-range programs. These include voluntary conservation, a fiscal policy change of potential significance, increased assistance for the immediate victims of a slowdown, and a monitoring of wages and prices.

But what I want to emphasize is the proposed fiscal package. That package deserves careful attention. In the excitement over the surtax proposal, the fact that what was proposed was a complete package has been lost in the public eye. The complete package proposed was first

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of all, limiting total federal spending to $300 billion in fiscal 1975 and a tight budget in fiscal 1976. Second, it was the passage of a tax reform bill that would close some major loopholes, including phasing out of the oil depletion allowances and increasing the special tax on sheltered income. Third, it was a modification of the capital gains tax to relieve the tax burden on inflation-created book profits on assets held for very long periods. Fourth, it was an increase in the investment tax credit to stimulate capital investment, and, finally, there was the one-year surtax to cover the cost of special programs for extended unemployment benefits and added public service employment in order to make the $300 billion limit possible.

This fiscal program was intended as a complete package and must be judged as a package. In that framework, I think it is an effective program. It is, of course, likely that the Congress will modify the package substantially before they have finished massaging it, but I would hope that, with election pressures behind them, the end result achieves greater budget control this year and a real tight budget for next year which will be proposed in January. It is still easier to pass increased spending programs than increased revenue programs but that temptation should be strongly resisted by the Congress.

Changes in fiscal policy come slowly because they require the joint action of the President and Congress. However, even before the economic summit, the proposal to hold fiscal 1975 spending to $300 billion was being carefully considered by the Administration and had widespread support in Congress. This level, together with the Treasury's estimate

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of increased revenues, would lower the deficit to about the same level as for 1974, $3 to $4 billion, well below the $12 billion originally expected. The Administration had also earlier pledged to plan a tight budget for fiscal 1976.

The reason that it is essential in my view that these steps be implemented is that the funds to finance a significant federal deficit can come from only two places: the general public in competition with funds for private investment, or from the Federal Reserve System. In the latter case, the problem of implementing proper noninflationary monetary policy becomes difficult, if not impossible. For example, between the beginning of fiscal 1968, and fiscal 1974, just ended, the accumulated federal deficit has totaled $89 billion. Of this total, the Federal Reserve System financed about $37 billion, or nearly 42 percent.

Once inflation was underway, the expectations for further price advances increasing and private credit demands soaring, just imagine what interest rates would have been and the disruption that would have been caused if the Fed had failed to assist partially in the U. S. Treasury's financing of the deficit.

In the current state of the economy, the kind of fiscal program proposed by the President, rather than a program of either strong stimulus or drastic restraint, seems a sensible course to follow. An appropriate fiscal policy can play a major role in setting us back on the path toward reasonable growth and more stable prices, not just by taking pressure off the financial markets now but also by restoring public confidence in the longer-term fiscal responsibility of the government.

But monetary policy, which has probably been the most effective inflation-control tool employed in 1974, still has a continuing important

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role to play in achieving our goals. While we have not seen fully the impacts of a restrictive monetary policy during the past year--and particularly this past summer--I do not feel that we can relax, feeling that the inflation fight has been won. It hasn't.

We know that any actions taken will have their principle effects not today but some months hence. We should not expect immediate price restraint from restrictive monetary actions. We know that lags exist, that they are variable, and that they are not precisely measurable after the fact, much less predictable. So great care must be taken not to over-stay whatever restriction is adopted and precipitate a serious economic downturn.

Yet you cannot move away from restraint too soon or too rapidly, lest you lose all that you are after--reduced price pressures. And the timing poses serious problems since a restrictive monetary policy can result in increased unemployment far more quickly than it can result in decreased inflation. We know too that the expectations of consumers, businessmen, government officials, and financial market participants play a critical role in a situation of persistent inflation. These expectations are affected primarily by performance, not by promises--and even then slowly. Unfortunately, the response may be even slower today because of the experience since the mid-1960s with what appears to be successively more difficult bouts with successively more stubborn inflationary periods.

Thus, in my view, we must move cautiously yet firmly with our restrictive actions and be prepared to adhere to those policies long enough for the effects to be felt. So let's not dump the baby out with the bath water.

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Even though we are not yet out of the woods, we can, with appropriate application of the "Old-Time Religion," begin to see better prospects ahead. The decline in short-term interest rates, the flattening, and, in some instances, declines in raw materials prices, the continuing high levels of investment in plant and equipment are all promising signs of a better future a year or so down the road. The U. S. economy is still fundamentally the strongest in the world. If we maintain our resolve, not only to reduce the inflation rate now but to continue to remember the lessons we have learned, the longer-term economic outlook is as bright as at any time in our history.

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