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W. Braddock Hickman
Joint Meeting of the
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ECONOMIC ROUNDUP

At a similar meeting a year ago of our joint boards of directors and guests, I indicated that economic activity was too exuberant and that continued expansion in our domestic economy and sustained improvement in our balance of payments were threatened by inflation. A number of restrictive policy actions have been taken since then. Up to this point, however, there has been little evidence of any slowdown in current spending flows or any visible abatement in inflationary pressures.

Nevertheless, a close examination of business statistics does suggest that some slackening in the real rate of growth is occurring, and if this proceeds long enough and far enough, it must ultimately bring about a reduced rate of price inflation. For example, the annual rate of change in GNP, after adjustment for price changes, dropped from 5% in the third quarter of 1968, to 3 1/2% in the fourth quarter, and then to about 3% in the first quarter of this year. The real growth in disposable income declined sharply in the first quarter, in part reflecting increased social security taxes and the surtax, and the rate of increase in retail sales, adjusted for price changes, diminished as the first quarter progressed, and turned negative in March. The unemployment rate has increased fractionally in the past two months, rising from a 15-year low of 3.3% in February, to 3.4% in March, to 3.5% at mid-April. Although admittedly some of these changes are small and others reflect temporary factors such as retroactive tax payments, they are nevertheless welcome signs indicating that we may finally be moving in the right direction.

Despite these hopeful signs, prices in some sectors still appear to be rising at an accelerating pace. The latest gain in consumer prices is alarming, with consumer prices rising in March at the fastest pace since February 1951. Wholesale prices also rose sharply in March, although the latest estimate for April indicates a slower rise, largely because of a reversal of an earlier sharp run-up in lumber and plywood prices.

Changes in current spending flows reflect changes in prices and changes in real product. As a result of sharp price increases offset by some moderation in real growth, current spending flows in the economy have not declined as much as we had hoped. For example, current dollar GNP increased by $16 billion in the first quarter, only fractionally less than in the fourth quarter of 1968. It appears that further declines in the real rate of growth of output, with an associated further rise in unemployment and fall in plant utilization, will be needed to dampen price changes and bring inflation under control within a reasonable period of time. *

Real rates of growth in the economy, and prices, are influenced by past patterns of monetary and fiscal policy. Monetary policy has been

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*If we assume a rate of real growth of potential GNP of 4%, then an economy such as the present one growing at a rate of about 3% will induce a rising unemployment rate and reduced utilization of plant capacity, but only over a longer period of time than an economy growing at a substantially lower rate.

moving toward greater restraint ever since mid-December, 1968, and in my opinion should not become more restrictive than it is at present. Since last December the credit proxy and reserve aggregates have actually declined, and the growth of the money supply has fallen appreciably. The current 6% discount rate is the highest in 40 years, and market interest rates have either reached or been near historic highs until very recently. By past standards, monetary policy now is highly restrictive. Additional monetary restraint would run the risk of precipitating serious financial distortions and possibly a monetary crisis.

Today, it seems to me that the appropriate policy for the prudent policy-maker is to pause a bit and allow past policy actions a chance to work themselves out. Sufficient monetary and fiscal restraint may already have been put in train, although the effects may not be readily apparent because of the time lags involved. We should be cautious about initiating new measures until we can appraise the effects of those already taken; but if it eventually appears that further policy actions are needed, then I believe they should come largely from the side of further fiscal restraint.

Moreover, we should recognize the serious limitations of fiscal policy -- both economic and political. In addition to the time lags and the problems associated with estimating the effects of tax and expenditure changes, fiscal programs have a way of devolving in unexpected ways as they proceed through Congress. The recent proposals of the Administration provide a classical illustration of this point. The initial proposal called for the repeal of the 7% investment tax credit effective April 21, and a reduction in the tax surcharge from 10% to 5% effective January 1, 1970.

However, the fiscal package now being discussed in Congress has become increasingly complex in order to secure the necessary votes for passage, and has become intertwined with proposals for tax reform and expenditure cuts.

In effect, the tax credit and surcharge proposals, if enacted, will remove an extra incentive for capital spending, and at the same time shift some of the tax burden from individuals to business firms. While the repeal of the tax credit would be a step toward restraining excessive capital spending, the desirability of lowering the tax surcharge next January will depend upon our progress in combating inflation; and we cannot adequately judge that progress at this time, since actions already taken have not yet had a chance to work themselves out.

In any event, it is extremely difficult to determine the net effect of such a diverse and complex fiscal package as Congress is now considering, which includes tax reductions, reforms, and expenditure cuts. It is at least possible that if all of these proposals are adopted we may run the risk of too much restraint. Given the current state of economic knowledge, and the desire to move slowly rather than in large discontinuous jumps, it would be far better to give the Administration the power to vary the surtax within a general range of, say, plus or minus 5%, as needed. Under such a program, we would not have to commit ourselves to too much or too little restraint so far in advance of economic events. Without such discretionary ability, we can only hope that the proposed fiscal package will prove to be realistic and appropriate in terms of magnitude and timing. Fortunately, monetary policy is a flexible instrument; it can react quickly if it becomes apparent that further corrective action is needed.