THE PRESENT ECONOMIC CLIMATE

Hugh D. Galusha, Jr.
President
Federal Reserve Bank of Minneapolis

Remarks prepared for the American Association of Cereal Chemists, Leamington Hotel, Minneapolis, Minnesota, October 19, 1970

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

INTRODUCTION

The title of my remarks, as it appears in your program, is "The Present Economic Climate." I should think, though, that you are interested in today's climate mostly for what it suggests about tomorrow's climate; and that, tomorrow's climate is what I want to talk about this morning. You all know that we have had quite a storm and, if I may continue with the metaphor of my title, that it is still raining--quite hard, in fact. But what of tomorrow's weather? I believe that the rain is going to let up and, in the not-too-distant future, stop. Unless economic policy is changed drastically, inflation will end; and, after awhile, unemployment will decrease.

I am not, however, forecasting fine sunny weather. The sky could well remain overcast. At best, I suspect, it can clear only partly. When we have brought inflation to an end, as surely we can, we will still be faced with the problem of reconciling price stability and full-employment, our two primary and equally important economic goals. But I am not entirely sure that we are going to find a way of completely reconciling these goals. I do not at this moment know of a way of doing so. This is why I say that the sky will remain cloudy or, at best, partly so. Having stated my forecast, let me tell you how I developed it.

THE NEED FOR CLOUD-SEEDING

As I said a few moments ago, we have had quite a storm--one which, if unchecked, might possibly have grown into a hurricane and threatened great destruction. The GNP deflator, so-called, is our broadest measure of inflation and, if not a perfect measure, the one most economists and government officials use. In 1965, the deflator increased about 2 percent.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

By historical standards, this is not a large increase. In 1966, however, the increase was nearly 3 percent; and in 1967, a little more than 3 percent. In 1968, the deflator increased 4 percent. Through 1968, then, we had a storm which was gaining in intensity.

Nor is it difficult to find a cause for the storm. War does not, of necessity, have to result in inflation. Citizens can, through their elected representatives, choose to tax themselves to pay for war. We did not, however, get an increase in taxes when the Vietnam war effort was stepped up, so increased government demand started prices moving up. And the increase in government war demand, not offset early on by an increase in taxes, led to increases in private demands. So directly and indirectly, government demand forced a continuing increase in prices.

In a full-employment economy, which is what we were approaching in mid-1965, there is no way citizens can escape paying for a war--or, for that matter, any other government activity which requires economic resources. They can pay more taxes directly or, by living with inflation, pay more indirectly. But however much we may lament the income tax, it is a better tax than inflation. It is a less capricious tax; its burden is distributed more equitably, as I am sure you will all agree, than is the burden of inflation. This is why we should have had an increase in taxes soon after the decision to escalate the war in Vietnam was made.

It might be argued that we did not need a tax increase; or, in other words, that much tighter money (a sharp increase in interest rates) would have damped private demand and, as it were, made room for a noninflationary increase in defense spending. Perhaps! The Fed did move; you will recall in this connection that discount rates were increased in December 1965,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

before it had become apparent to all that the Vietnam war effort was being escalated. But U. S. economic policy cannot be set by monetary policy alone, for its effect, unless coordinated with fiscal policy (the other half of U. S. economic policy) is highly selective in very unpleasant ways. For example, tight money bears most heavily on housing, and on beleaguered state and local governments.

In any event, we finally did get a tax increase in the summer of 1968 and then, in early 1969, a sharp increase in monetary restraint; coupled with a decrease in defense spending which has continued down to the present and will, I think, continue through the near-term future. And the economy responded. Aggregate demand decreased and the dangerous rate of economic growth slowed.

THE RAIN WILL END

I must admit that in 1969 the GNP deflator increased nearly 5 percent, or more than in 1968. All this means, however, is that inflation cannot be ended overnight. Especially is this so if it has gone unchecked for a long while and businessmen and consumers (who are also, for the most part, wage-earners) come to expect that it will continue. I must also admit that, like most public officials, I have been a little disappointed by the increases in prices in 1970. But only a little. It was Lenin, I believe, who said that only those who start with illusions are ever disillusioned. And most public officials, whatever their public pronouncements, did not start with the illusion that 1969 or even 1970 would see a return to price stability.

The outlook for the near term is for more inflation, but, what is most important, at a steadily decreasing rate. In early 1971, the rate

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of inflation may be only 3 percent. While I do not regard a 3 percent rate of inflation as acceptable, it is a lot better than a 5 percent rate. In late 1971, the rate of inflation could well be down towards 2 percent, which is very nearly what we have come to mean by price stability.

How can I say what I have just said when the prospect is for a very considerable federal budget deficit for the current fiscal year, which will end next June? A deficit somewhere in the range of $10-13 billion, where in fiscal 1970, the year which ended last June, we had a small surplus--something less than $1 billion? So again, how can I say that the rate of inflation is going to decrease when the prospect is for a large budget deficit in fiscal 1971?

There are two reasons. The first is that the increase in the budget deficit is partly explained by the economic slow-down. When the economy slows down, tax receipts fall and, other things equal, the actual budget deficit increases. In fiscal 1970, federal receipts totaled roughly $200 billion; and the estimate is that in fiscal 1971, receipts will total only about $196 billion.

The point is that the level of economic activity has an influence on the federal budget. When the rate of economic growth increases, the budget swings automatically toward surplus because as profits and incomes grow, so do taxes. And when the rate of economic expansion decreases, as it has, there is an automatic swing toward deficit. A shift from budget surplus to deficit is therefore entirely consistent with a decreasing rate of inflation, since to get a decreasing rate of inflation requires an economic slow-down; and as I have already indicated, such a slow-down tends, other things equal, to swing the budget

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

from surplus to deficit.

Because the actual budget is influenced so by the level of economic activity, it is not a good measure of fiscal fuel. A better, although far from perfect, measure is what economists call the full-employment budget. It is calculated by estimating the revenues the government would receive if the economy was operating at full employment, with the levels of business profits and personal incomes consistent with that level of employment. It is not influenced by current economic conditions; it changes only when federal spending changes, or when there is a change in tax rates. It therefore furnishes a neutral yardstick to measure the inflationary impact of fiscal programs.

We estimate that for fiscal 1970 the full-employment budget was in surplus by about $5 billion and that for fiscal 1971 there will still be a surplus of approximately $1 billion. Fiscal policy will be more expansionary on average in the present fiscal year than in the one just past. For one thing, there is going to be an increase in federal spending--a modest increase, when measured against the trend increase in federal tax receipts, but an increase nonetheless. But a decrease of $3-4 billion in the full-employment budget surplus appears rather insignificant in a $1 trillion economy. And besides, private demand is not increasing all that rapidly. Quite the opposite. We can use a little fiscal stimulus, for bringing an end to inflation does not require recession of major proportions; and without some fiscal stimulus, or alternatively greater monetary ease, that is

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

precisely what we could get. It is then a certain weakness in private demand that explains, if only in part, why an increase in federal spending and a swing from budget surplus to deficit is not inconsistent with a decrease in the rate of inflation.

On my bad days, I do worry a little, I must confess, about Congress forcing an even larger increase in federal nondefense spending than is presently in prospect. There will be some increase, as I have said, but what worries me is a further sharp increase. The Administration has given every indication it will resist. But if Congress should press successfully for sharply higher nondefense spending, then we will not be able to have the easier money which, in my opinion, this economy needs. The Federal Reserve will have to modify its decision, made earlier this year, to be more generous in providing funds to the economy. And if it does have to, then state and local governments will again come under pressure and our national housing goal will remain way beyond our reach. The margin created by relative fiscal restraint--a margin which has made it possible for monetary policy to relax without having to worry excessively about adding to inflation pressures--will be seriously narrowed.

It is therefore very important that the Administration succeed in keeping nondefense spending under control. If it does not, then there could well be a little more inflation than there otherwise would be. The rate of inflation will still decline, but not quite as rapidly. The point is that the Federal Reserve will step into the breach. Of this I am entirely confident.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

And yet if it is forced to, then housing, school construction and investment spending will suffer.

What I am saying can be put simply: The economy needs some relief from tight money; but if the rate of inflation is to be slowed, the only way to get easier money is by holding federal spending down to the level currently in prospect. I should have preferred holding it below this level and having that much easier a monetary policy.

THE COST OF CLOUD-SEEDING

I have likened inflation to a rain storm, to a storm which threatens to become ever more violent; and I have likened economic policy intended to check inflation, the tax increase of 1968 and the extreme monetary restraint of 1969, to cloud-seeding. And such a policy is costly, just as cloud-seeding is. There may be no bills for rented airplanes and gasoline, but there is a cost: lost output or, alternatively, increased unemployment.

In December 1968 the unemployment rate was 3.3 percent. In September 1970 it was 5.5 percent. Last month roughly 1.8 million more individuals were unemployed than in December 1968. However bad our unemployment statistics are, there is no denying that slowing the rate of inflation has been costly.

Actually, the unemployment rate has increased more than most experts expected. It is my impression that sometime back the mood of businessmen changed, perhaps from excessive optimism to equally excessive

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

pessimism, and that when this happened they predictably launched a massive cost-cutting effort. Predictably, because there are only two ways to enhance corporate profits: by increasing sales or by cutting costs. Denied the former by the forced slow-up in the economy, they have turned to the latter. They are doing it successfully; unit labor costs are decreasing. But, and this is a very large qualification, this cost-cutting effort has had the effect of increasing unemployment. And since cost-cutting efforts are likely to continue, unemployment could for awhile continue higher than one might hope for.

Do not misunderstand me. I am not inveighing against cost-cutting. I am all for cutting costs, especially since I believe that with proper economic policies we can provide job opportunities for those who as a result become unemployed. Cost-cutting is an offset--a short-run offset, but an offset nonetheless--to money wage increases. And in today's climate, we can be grateful that cost-cutting has become a favorite indoor game of businessmen. I should not be so optimistic about our returning to reasonable price stability if I did not believe this.

Cost-cutting has, however, as I have said, made the unemployment problem worse. And it is difficult to see unemployment decreasing in the months immediately ahead. The unemployment rate will likely go on increasing for some months, I think, but happily at an ever slower rate. For awhile yet, we will be paying a higher and higher price for slowing the rate of inflation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Looking a little further into the future, to beyond mid-1971, I do see a decrease in the unemployment rate. Economic policy has become more expansionary. The income surtax came off at mid-year and monetary policy is certainly more expansionary than it was in early 1970. There is a lag in the effect of economic policy, but the economy does respond. The real growth rate is higher today than it was earlier in 1970 and through 1971 will, I suspect, continue to increase.

And what is most important, the rate of inflation will go on slowing as the rate of real economic growth increases and the unemployment rate decreases.

The steady progress could be derailed. I have touched upon the danger of relaxing fiscal restraint too fast in domestic programs. The Middle East is a worry, and Southeast Asia is a long way from settled. Hysteria, however induced, will continue to be a worrisome threat. Modern man may look like, and sometimes act like, the super-rational economic man some young people deride. They need not worry. Emotion is still a determinant of human behavior, even in financial markets: Policymakers, at least in the short run, have to mix an awareness of psychology with economics. In some parts of the Ninth District, there are those who are preparing for the end of the financial world at 9:30 a.m. on Friday, November 13, because they read it somewhere. In one community, following a recent newsstory, the banks were confronted by a succession of withdrawals from savings accounts, and the local brokerage office had a flood of sell orders. The young reporter who had never dreamed his story would

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

produce that kind of response has, I'm sure, a feeling of kinship with the radio station in New Jersey that years ago carried the fictional play by Orson Welles about the men from Mars who landed in New Jersey.

But lest we be too hard on either our Ninth District community or those in New Jersey, the irrational response of large, eminently respectable investors to the Penn Central collapse was no different. Penn Central failed because of appalling mismanagement; but all of a sudden the whole commercial paper market became a shambles, with acute pressures focussed on two well-run commercial paper issuers, Chrysler Acceptance and Commercial Credit. The Fed moved quickly to bolster financial confidence, and the crisis was averted. It can and will continue to perform that role of banker of last resort to maintain orderly financial markets, but it hardly makes easier the progress toward long-term economic goals.

To a point, then, I am rather optimistic. I see the rate of inflation decreasing steadily over coming calendar quarters and, after awhile, the rate of unemployment decreasing too. Economic policy had to become very restrictive. To check inflationary pressures, the rate of economic growth had to be decreased. We had to create a large gap between the economy's capacity output and actual output, or in other words force some increase in the unemployment rate. But this large output gap does not have to be maintained. We can reduce it, and thereby the unemployment rate, and still achieve further decreases in the rate of inflation.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

THE OUTLOOK: CONTINUED OVERCAST

It might seem from what I have just said that I am indeed looking for a return of sunny skies. I should prefer, though, to put my forecast differently: the rain will stop, but skies will remain overcast.

Why should I refuse to admit of a disappearance of the clouds and the appearance of the sun? It is just that I wonder whether we will be able to proceed back to full-employment--to a 4 percent unemployment rate which is the conventional definition of full-employment--and remain there, while at the same time enjoying price stability. Possible by proceeding only very slowly back to full-employment, we could remain there and still have stable prices. There are some economists, very experienced in economic policy, who believe this. I should like to be a believer, but have not been able, try as I might, to rid myself of doubt.

The evidence, such as it is, suggests that full-employment, 4 percent unemployment, and price stability are irreconcilable goals; or, in other words, that both cannot be achieved. It is not reassuring to look back to the early 1960's. We had price stability over a stretch of years, 1960-64, but with an average unemployment rate of nearly 6 percent. Over the years 1965-69 the unemployment rate averaged a little less than 4 percent. But over those years there was, as I have said, a very considerable increase in prices.

Nor is it acceptable to argue, as some have, that we should accept whatever unemployment rate is consistent with price stability, be it 5 percent or, worse, 6 percent. That is too easy a way out. For one thing, the burden of a high unemployment rate is very specific; it is shared only by those who are unemployed. Keeping inflation in check benefits many; certainly

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

all those who have retired and those who remain employed, but at the expense of those who, to keep inflation in check, have become unemployed.

And it cannot be maintained that the unemployed are unemployed because they are unwilling to work. Is it possible that in less than two years 1.8 million more individuals suddenly became too lazy to work? I think not. Beyond a certain margin, unemployment is the result of economic policy. And it is not good social policy, I submit, to have a small proportion of the population bear a very considerable economic burden -- unemployment -- so that the much larger proportion can enjoy price stability.

There are some who would have mandatory wage and price controls imposed. Most emphatically, however, I do not count myself among those who would. I shudder when I think of the bureaucracy that would be required to assure even partial -- not complete, but partial -- compliance. It might be different if a successful appeal could be made to patriotism. And we are not smart enough, it seems to me, to regulate wages and prices without badly allocating economic resources or causing economic waste. In brief, then, I should prefer inflation, or even excessive unemployment, to mandatory wage and price controls.

Among those whom I greatly respect, there are some -- perhaps many -- who favor voluntary wage-price guidelines. And perhaps we should have another try at voluntary restraint. I, though, am a little doubtful that we accomplish much by trying. Also, I dislike policies which, so to speak, put those who are willing to cooperate at a disadvantage.

If the goal of 4 percent unemployment rate and the goal of price stability are inconsistent, as I sometimes think they are, and if a policy

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

of voluntary wage-price restraint will do little if any good, then the economic outlook is not all that bright. It clearly behooves us to do all that we can to make our overriding goals of economic policy, full-employment and price stability, more compatible. Labor mobility might be improved further, perhaps with the help of government. Trade quotas and tariffs might be eliminated or at least reduced.

But as I said at the outset, I do not know how full-employment and price stability can be made fully compatible. Perhaps the experts do. All I know is that even after inflation has been stopped, a problem may remain and that, unless a way of reconciling full-employment and price stability is found, our free market economy will be impaired.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis