THE ROAD TO CONFIDENCE

Talk by

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The biggest economic problem in 1971 is how to regain confidence. Surveys indicate that consumer confidence is about the lowest in the 8 years it has been recorded. Corporate profits are well below their peak of 2 and 3 years ago, and businessmen are still worried about the shape of their balance sheets. Wages are rising at about 5 per cent a year, but wage earners' real purchasing power has hardly risen at all. More people are out of work than in nearly a decade. Prices are setting new records every month. The balance-of-payments deficit last year was higher than it has ever been.

All this is discouraging. What is most discouraging, though, is that progress in solving these problems is so slow. The public has been asked to be patient, but patience is running out.

I'd like to talk today about chances of a confidence breakthrough in 1971. To do this I want to look, first, at what I'd like to see happen this year; second, what seems most likely to happen; and, third, what kind of policy will best restore a confidence that will last.

What I'd like to see happen

The ideal road to confidence would be by a rapid and lasting recovery--with unemployment dropping quickly and the rate of inflation moving steadily downward. An ideal recovery might go something like this:

The consumer comes alive again. Instead of paying off his debts and saving at near record levels, he starts spending, especially for big ticket items like cars, color television sets, refrigerators, furniture. He comes up out of the bargain basement and spends on quality items.

With the consumer spending, the businessman starts to regain confidence. Merchants build their stocks. New orders pour into manufacturers and order backlogs rise. Industrial production rises rapidly and excess capacity dwindles.

With unutilized capacity on the downslide, businessmen step up their purchases of new plant and equipment. Liberalized depreciation allowances, receptive bankers, lower interest rates, and rising profits make funds available for investment.

Funds would be available to support a healthy housing boom, and houses would become available at prices people could afford.

This is, perhaps, a classical pattern of business recovery, the traditional road to new confidence. In the process, unemployment would drop from 6 to 5½ to 5 to 4½ per cent, and so on. At the same time, the rate of inflation would continue to decline from 5 to 4 to 3 per cent.

This happy combination of declining unemployment and diminishing inflation could occur because, even though the economy would be accelerating, there would for a considerable time be enough slack to keep prices from rising. Moreover, with output increasing, productivity would be rising rapidly, holding down costs per unit of output.

What kind of public policy would we have? As you know, the President has adopted the high employment budget concept as his guide to prudent fiscal policy. In essence, the high employment budget concept says that Government spending ought to equal Government revenues at full employment, defined as a 4 per cent rate of unemployment.

As long as unemployment remained high, the Federal Government would run large deficits--thus helping to stimulate the economy and create jobs. As unemployment decreased, the budget deficit would shrink because more people would be paying more taxes. Finally, when unemployment reached 4 per cent, the budget would be balanced. Should the economy become overheated and unemployment fall below 4 per cent, the budget would run a surplus, and this would act as a check on excess demand.

I believe the high employment concept is a major step forward in fiscal policy. Had we followed it in the 1960's, particularly during the Vietnam buildup, we almost certainly would not have the inflation problem we have today. And I believe if we follow it in the future, we will go a long way toward avoiding new rounds of inflation.

What kind of monetary policy would we have during this ideal recovery? The Federal Reserve would allow money and credit to grow fast enough for unemployment to drop without planting the seeds for future inflation.

Thus the budget and the Federal Reserve would be encouraging recovery by stimulating demand. If there were tendencies for prices to be pushed upward by cost pressures, voluntary wage-price guidelines could be invoked. Business and labor would cooperate in observing the guidelines because they would realize that price stability is in their own long-run interest as well as the public interest.

Now, I'm not just trying to paint a pretty picture. This is not only in many respects the traditional road back to confidence, but it is the course some people are predicting the economy will take in 1971. I hope they are right. But what are the probabilities?

What will likely happen?

In my judgment, the chances of this pattern occurring are on the low side. The odds are against a rapid and smooth return of confidence. I say this because the situation we are dealing with is unlike any we have faced before. We have had a worse economy before, but we also expected less of it. The gap between performance and expectations is probably wider than it has ever been. The low level of confidence naturally reflects this gap. At the same time, assurance that we know how and are able to deal with our problems has been shaken by their very complexity and by the slow progress in solving them.

What seems more likely to me, therefore, is that the economy will recover gradually rather than rapidly. Unemployment will fall, but slowly rather than precipitously. And the rate of inflation will drop, but not dramatically.

Let's look more closely at what is likely to happen to important sectors in the economy:

The consumer will likely open his wallet a little wider in the coming months. He is likely to become somewhat more confident about the economic outlook. But he will still know somebody who is unemployed and inflation will still be chipping away at his paycheck. So he is likely to remain cautious about how he spends his money. He's still going to look for bargains; he's still going to be reluctant about incurring new debt. In short, the consumer is likely to feel that the worst is over as far as the economy is concerned but that things are still too uncertain to throw caution to the winds.

Likewise, the businessman is going to feel better about the economy, but probably not exuberant. Most businessmen will probably keep a sharp eye on inventories. They would rather take a chance on being too low on stocks than being too high, especially since inventory-sales ratios are currently on the high side. And, as long as unused capacity remains high--currently over one-fourth of industrial capacity is standing idle--it is doubtful that business will increase outlays on new plant and equipment.

As for housing, this sector probably has the greatest chance of being strong in 1971. There is a big demand for housing and funds are becoming available for financing. But the outlook is clouded by rising costs.

In short, the probabilities seem to point to a GNP well under $1,065 billion, to a gradual recovery rather than a rapid one.

A gradual recovery means that unemployment probably will continue to rise for a time. The reason is that new people, such as returning servicemen and teenagers, come into the labor force each year. If the economy does not grow fast enough to generate jobs for them, some will end up being unemployed. This seems likely until about mid-year. Then unemployment should level off and begin to fall.

On the inflation front, in contrast to what I would like to see happen, I suspect we're in for only slow progress. Demand-pull inflation is dead, but cost-push inflation remains very much alive. Although wages are rising less rapidly in non-unionized industries, union wage settlements do not seem to be abating. Gains in productivity will help to moderate cost pressures to some extent, but sustainable progress against inflation will not come until wage settlements become more moderate. So, I suspect that we will see some unwinding of inflation, but progress will be disappointingly slow.

Given this kind of outlook in the private sector, what can we expect from public policy? For one thing, with inflation continuing stubborn, we will probably hear more about an incomes policy. People will continue to debate about it: Can it work? Would it do more good than harm? Specifically, what should it be? Should it be voluntary or mandatory? etc. We could debate the matter here, but the important question is, what is likely to happen? My guess is that efforts to deal directly with wages and prices will have some effect but far less than most advocates of an incomes policy would hope.

As far as the budget is concerned, a slower recovery would mean a larger deficit than officially forecast. The deficit would be larger because there would be a smaller increase in tax receipts. Also, Federal expenditures may exceed the $229 billion figure in the President's proposed budget.

These kinds of probabilities raise important questions for the Federal Reserve. I believe that the Federal Reserve should provide enough money and credit for the economy to expand so that unemployment can be reduced. But, I also believe that the Fed must continue to be concerned about inflation. In other words, the Fed should not allow money and credit to expand so rapidly in 1971 that we plant the seeds for another inflationary spiral in 1972 or 1973.

Conclusions

The road back to confidence does not seem likely to be smooth or easy--or short. This news will disappoint some impatient, disillusioned people and could make the return to confidence even harder. But there are great risks in promising too much.

Man is an adaptable creature. During an inflation of five years, the worst in twenty, he has adapted. He can adapt again to a non-inflationary economy, but it is unreasonable to expect him to do this rapidly and easily.

You may not like the prospects of only a gradual economic recovery, but the chances of ending up with lasting confidence in a stable and prosperous economy seem better if we take this route. If we try to go too fast, we could end up with even worse inflation. Public policy should take the economy along a course that brings gradual, steady improvement without stimulating new inflationary pressures. The road back may be longer, but when we get to our destination we're more likely to stay for a while.

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