# THE STATE OF CONFIDENCE: SHORT AND LONG RUN

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Since August 15 business analysts have been giving the public an especially concentrated treatment of psychoanalysis to ascertain how it will behave under the new economic program. That elusive state, confidence, has become all important. Today I should like to make my small contribution to this discussion. The essence of what I'm going to say is that the state of confidence is reassuring in the short run, but disturbing in the longer run.

## Short run

The first reaction to the new economic program was a strong resurgence of confidence. This was testimony to the appeal of the program, but also to the low ebb which confidence had reached before August 15.

The general feeling was that things were out of control. No one could take the decisive action necessary to deal with the cumulative spiral of inflation amid high unemployment. The Government seemed unable to deal effectively with inflation without making unemployment worse, or to deal with unemployment without making inflation worse. Business, with profit margins lower than any time in the past 25 years, had to pass higher wage costs along in the form of higher prices. Union leaders felt obliged to protect their members against the inroads of higher living costs. Consumers could do little but complain about prices and tighten their belts while watching friends and neighbors being laid off; unemployment had become more than a statistic or a social phenomenon, it was coming too close for comfort for too many people.

President Nixon's program reversed all this overnight. The question now is how long will confidence stay high. Some signs suggest that it has already receded somewhat. The stock market, for example, seems to be pessimistic. On the other hand, the bond market has been quite strong recently. Different forces are probably at work in these markets, and it may be that the only clue to the state of confidence is telephone calls to business executives and conversations with taxi drivers. In both cases the prevailing mood seems to be one of watchful uncertainty.

There is good reason to believe, however, that confidence should be fairly high through at least the first half of next year. Our projections assume a substantial degree of success of Phase II. To a considerable extent, therefore, the projections are predetermined by the assumptions. Nevertheless, these assumptions seem the right ones to make, at least when looking at the first half of next year. If Phase II ultimately proves a big disappointment, this is not likely to become obvious before June.

Consumer spending is virtually certain to rise fairly strongly and the savings rate to come down. Business should be building inventory more rapidly. Housing will continue to be strong. State and local governments will be spending heavily. Profits should be increasing rapidly. Productivity will be rising. And despite some catch-up in wages and prices, the rate of increase should be markedly slower than before the freeze.

To attach some numbers to all this, we see GNP rising at an annual rate of around 10 per cent by midyear, with the price deflator accounting for only one-third of this. Unemployment may decline to around 5-1/2 per cent. If this kind of forecast materializes, there will be good reason for sustained confidence.

What will happen in the second half is, of course, much harder to predict. Whatever cracks develop in Phase II--and everybody is already busy looking for them--may be widening by then. If the public expects too much, confidence will deteriorate. But if people can be persuaded that a moderate rate of price increase and unemployment in the 4-5 per cent range, although not ideal, nevertheless represents progress, their confidence may not suffer seriously. Economists have pointed out many times that other attempts with incomes policies are not reassuring. I believe the effort should be pursued aggressively, but I also think it is important not to be unrealistic about the degree of success to expect of it.

The short-run outlook for confidence, therefore, seems quite good. An improved economy should help to sustain confidence and a confident public should help to promote a better economy.

Longer run

In the longer run--and by this I'm thinking of the 70's--there is some reason for concern. One reason is that both inflation and unemployment may be stubborn. Inflationary pressures seem likely to recur, basically because there are so many things society insists on doing with its limited resources. It wants further increases in material things for more people plus a cleaner environment, better health, education and welfare, more efficient transportation, and many other social goods and services. At the same time, with the economy becoming increasingly service oriented, it may be hard to maintain high productivity--perhaps the most potent single weapon against inflation. Finally, big business and big labor seem likely to be an institutional combination promoting continued cost-push pressure.

As for unemployment, it is unlikely that the hard core will be eliminated by the end of the decade. The problem of training and educating disadvantaged people to the point where they can become self-sufficient and productive members of society is too difficult and time-consuming to be completely solved by then. In addition, unemployment among middle-income, professional people may prove more than a temporary condition of the recent recession. There is a big surge of well-educated youth about to come onto the labor market. Many of them hope to find jobs in engineering, teaching, economics, and the sciences. Many of these may be frustrated. Others will put competitive pressure on middle-aged professionals already haunted by obsolescence.

The feeling of helplessness that prevailed before August 15, therefore, could recur and last for some time. The possibility would be enhanced if the current effort to deal with inflation and unemployment proves to be disappointing. And if this were to happen, an even more serious sag in confidence could be nurtured from seeds that I think I can detect even now. I refer to a basic lack of confidence in the market-oriented, competitive economic system which we have always thought to be typically American.

Before I give examples of what I mean, let me say two things. First, the attitude toward our economic system is only part of a mood which some expect to prevail in the 70's. In international politics it may take the form of isolationism. In domestic politics a turn toward conservatism. In social matters a reaction to the upheavals of the sixties. And in economics a search for insulation and protection from competition.

Secondly, I recognize that much of the economic history of this century consists of conscious effort to modify the harsh and extreme effects of a free competitive system. The progressive income tax, social security, pure food and drugs, the family assistance program--you name it--all are attempts on the part of society to achieve values which a free, competitive system seemed unable to provide. Also, I don't mean to give the impression that the system is untouchable; society should modify it to make it perform as desired; the economy is servant, not master.

Yet, if the great body of economics is at all correct, there is something in the way the market system works that produces desirable results. And despite the many modifications made to it in the past, we still have essentially a market system. What I'm concerned about in the longer run is a tendency to lose confidence in that system. Let me give two examples: protection against foreign competition and attempts to peg interest rates.

Economists differ notoriously on many things, but they are in solid agreement on the benefits of a system in which each nation concentrates on producing those things it can turn out most efficiently and trading them competitively with other nations. Unfortunately, the theory always comes up against some very difficult obstacles, one of the most formidable being that free competition can be uncomfortable. The history of foreign trade, therefore, is largely a record of various ingenious efforts to protect against competition, relieved by rare and brief periods of relaxation in barriers to trade. One of these rare intervals has just been completed, and we now may be in for a sustained period of protectionism.

The 10 per cent surcharge on imports is only the most prominent manifestation of a general protectionist movement. Hopefully, the surcharge will be removed as soon as it serves its purpose as a bargaining weapon in restructuring exchange rates. Perhaps the new structure of currencies will enable U.S. business to compete with greater confidence. It seems just as likely, however, that various forms of protection will proliferate. In this respect, the recent stagflation may prove to have had lasting effects. Inflation made it more difficult for business to compete abroad; unemployment made it more appealing to buy American. If a tendency toward inflation and unemployment is at all a plausible prediction for the 70's, the drive for protection seems likely to continue.

As for interest rates, history tells us that very influential people and groups have long wanted to keep them from fluctuating--at least on the upside. In recent years, Regulation Q has attempted to protect savings institutions and smaller banks against interest rate competition. I think it is now widely recognized that Regulation Q did not succeed in channeling funds into mortgages, as intended. Ceilings on rates paid for specific kinds of liabilities or charged on specific kinds of assets simply divert the business into uncontrolled channels. I hope--but am not at all certain--that this lesson will be given some heed in both the immediate and longer-run future.

Most importantly, I think there is likely to be a lack of confidence in the role which interest rates play in the economy and a lack of willingness to let them play it. Interest rates are a price unlike other prices. Because money occupies a pivotal position in the economy, the price of money is also pivotal.

This is a lesson learned painfully in and after World War II. Although to a number of you this lesson is now only history (it is almost exactly twenty years ago that slow and difficult steps were taken to recover from it), it has special meaning as we look ahead. For that experience demonstrated the impossibility of pegging interest rates and at the same time maintaining a stable economy. When the Federal Reserve attempts to fight tendencies for rates to rise, it is obliged to pump in new funds. Eventually this creates inflation and the investing public tries to protect itself by demanding still higher interest rates, calling, in turn, for the injection of still more funds and leading to a self-defeating cycle.

If we are to have a healthy economy in the 70's, we will need, at times, rising--and perhaps quite high--interest rates. If we lack the confidence to permit interest rates to do their job in allocating funds, if we lack confidence to let them respond to the exercise of monetary policy, we are not likely to be able to deal with the conditions likely to prevail in this decade.

## Conclusion

The degree of confidence which prevails at the moment is based on hope that extraordinary measures will bring stability and growth back to the economy. But this is a fragile kind of confidence because it is also based on doubts about whether the free competitive economy can ever again do the job we once thought it could do. John Fischer writes in the November *Harpers* that "the character of our whole society has changed so drastically during the past decade or two that it no longer responds to the so-called laws of economics....the competitive free enterprise system apparently has gone dead on us."

The greatest danger we face is that each group will be trying to insulate itself--labor by featherbedding, business by monopoly and quotas against imports, and the public at large (through Government) by a network of controls. To coin one of those alliterative descriptions of decades, we may be entering the Stifling Seventies.

It seems to me that the task of all those who claim some expertise in economics is to fight that tendency. This will take ingenuity and imagination because the economic system *is* changing; old solutions are *not* sufficient. But the competitive market system has worked well for us in the past and we should not lose confidence in its potential for the future.

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