

THE BUSINESS SCENE IN 1974

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JOHN BALLE is very sorry that he is unable to join you here today, especially since he was anxious to renew acquaintances with so many old friends. He has asked me to convey his regrets.

His intended remarks, which I shall present, are concerned largely with the problems of growth in the national economy. Every boom, like every convention cocktail party, contains within itself the seeds of a morning after. The boom of the 1971-73 period has been no exception. Whether we use the happy term "soft landing" or the ugly term "stagflation," we all recognize that we must pay at least some price in late 1973 and 1974 for the over-rapid growth of the recent past.

WHERE WE STAND

At the same time, I don't want to take anything away from the very substantial accomplishments of this boom period. The economy has grown almost 15 percent in size, in real terms, since the new economic policy burst on the scene in August of 1971. The boom also has created two million new jobs -- the greatest accomplishment in this area since the post-war demobilization period of 1945-47. In other words, policymakers

HAVE DONE WHAT THEY SET OUT TO DO -- THAT IS, STIMULATE THE ECONOMY TO SUPPLY THE GOODS AND SERVICES (AND JOBS) REQUIRED BY THE RAPID GROWTH OF THE WORKING-AGE POPULATION.

UNFORTUNATELY, THE OVERALL RECORD OF ACCOMPLISHMENT HAS BEEN BADLY MARRED BY AN INFLATION THAT HAS LEFT MOST OF US GROPING FOR DESCRIPTIVE ADJECTIVES. PART OF THE INFLATION PROBLEM IS BEYOND HUMAN CONTROL. FOR EXAMPLE, WE CAN'T DO MUCH ABOUT THE FACT THAT THE WORLD-WIDE GRAIN CROP DECLINED LAST YEAR FOR THE FIRST TIME IN MODERN HISTORY, CAUSING MAMMOTH FOOD SHORTAGES ABROAD. ANOTHER PART OF THE INFLATION PROBLEM ALSO IS LARGELY BEYOND THE CONTROL OF DOMESTIC POLICYMAKERS. WE CAN'T DO MUCH ABOUT THE FACT THAT VIRTUALLY ALL OF THE ECONOMIES OF THE DEVELOPED WORLD BEGAN TO BOOM AT THE SAME TIME, PLACING SEVERE PRESSURES ON INDUSTRIAL PRICES. WITH PRODUCTION EXPANDING EVERYWHERE, THERE HAS BEEN A SWELLING DEMAND FOR INDUSTRIAL MATERIALS, MACHINE TOOLS AND CAPITAL EQUIPMENT -- GOODS FOR WHICH THIS COUNTRY IS A MAJOR SOURCE OF SUPPLY. AND WITH THE DOLLAR ABOUT 20 PERCENT CHEAPER THAN IT WAS SEVERAL YEARS AGO, DEMAND FOR AMERICAN AGRICULTURAL AND INDUSTRIAL MATERIALS HAS SKYROCKETED. THESE DEVELOPMENTS HAVE PRODUCED MAJOR IMPROVEMENTS IN OUR BALANCE OF PAYMENTS, BUT THEY ALSO HAVE GENERATED EXTRA DIFFICULTIES FOR PRICES ON THE DOMESTIC FRONT.

SHARP PRICE INCREASES RESULTING FROM A WORLD-WIDE BOOM, A DEVALUED DOLLAR AND SIGNIFICANT SHORTAGES OF MATERIALS HAVE NOT BEEN AMENABLE TO NORMAL ANTI-INFLATION WEAPONS. THE SAME IS NOT TRUE, HOWEVER, OF THE INFLATION GENERATED BY THE OVER-RAPID PACE OF ECONOMIC EXPANSION HERE AT HOME. TO ATTACK THE DOMESTIC FACETS OF THE INFLATION PROBLEM, POLICYMAKERS SHIFTED AWAY FROM STIMULATIVE POLICIES IN THE FALL OF 1972, AND THESE ACTIONS SHOULD AFFECT THE TREND OF PRODUCTION AND PRICES IN 1974.

WHERE WE'RE HEADING

WHAT THEN SHOULD WE EXPECT NEXT YEAR? THE QUESTION IS DIFFICULT TO ANSWER, BECAUSE OF THE POLITICAL CRISES WHICH HAVE DEVELOPED RECENTLY ON THE BANKS OF THE POTOMAC AND ON THE BANKS OF THE SUEZ CANAL. I HAVE NO CRYSTAL BALL ON THE POLITICAL SCENE. HOWEVER, I DO HAVE SOME THOUGHTS ABOUT THE ECONOMIC FACTORS THAT WILL SHAPE BUSINESS ACTIVITY IN 1974, AND I'D LIKE TO SHARE THOSE THOUGHTS WITH YOU.

THE FORECAST PREPARED BY MY ECONOMIC STAFF SHOWS GNP RISING FROM \$1,155 BILLION IN 1972 TO ABOUT \$1,290 BILLION IN 1973, AND THEN TO ROUGHLY \$1,400 BILLION IN 1974. MORE INTERESTING IS THE DISTRIBUTION BETWEEN PRICES AND REAL OUTPUT. MY STAFF EXPECT A 6-PERCENT GAIN IN REAL GNP THIS YEAR -- ABOUT THE SAME AS IN 1972 -- BUT THIS SHOULD BE FOLLOWED BY A GAIN OF LESS THAN 3 PERCENT NEXT YEAR.

WE DON'T EXPECT THE INFLATION PROBLEM TO BE LICKED NEXT YEAR, ALTHOUGH SOME INROADS SHOULD BE MADE ON THAT PROBLEM. AFTER RISING 3 PERCENT IN 1972, THE GNP PRICE INDEX PROBABLY WILL RISE ABOUT 6 PERCENT THIS YEAR, AND BY ROUGHLY AS MUCH IN 1974. HOWEVER, WE MAY ALREADY HAVE PASSED THE WORST IN THIS REGARD, AND THE PRICE RISE SHOULD DECELERATE AS WE MOVE THROUGH 1974.

ONE MAJOR QUESTION MARK CONCERNS THE EXPLOSIVE MIXTURE OF THE MIDDLE EAST WAR AND MIDDLE EAST OIL. THIS SITUATION CAN DISTORT MARKETS, ACCENTUATE SHORTAGES AND ADD TO DOMESTIC INFLATIONARY PRESSURES. MILITARY SPENDING, WHICH HAS RISEN SLOWLY FROM THE POST-VIETNAM LOW POINT IN 1971, MAY RISE SOMEWHAT FASTER IN THE WAKE OF THE MIDDLE EAST CRISIS. BUT EVEN AFTER PEACE IS ACHIEVED IN THAT AREA, THE ECONOMIES OF THE INDUSTRIAL WORLD WILL REMAIN AT THE MERCY OF AN UNRELIABLE AND INCREASINGLY EXPENSIVE ENERGY SOURCE.

IN ADDITION, WE WILL FACE SEVERAL SOFT SPOTS IN THE 1974 ECONOMY, HOUSING IN PARTICULAR. DOLLAR SPENDING FOR HOUSING REACHED A HIGH PLATEAU EARLY THIS YEAR, BUT NEW HOUSING STARTS HAVE BEEN DECLINING FOR SOME MONTHS, RATHER STEEPLY IN SEPTEMBER. (YOU'LL NOTICE, INCIDENTALLY, THAT BASIC DEMAND SLACKENED, AND HOUSING STARTS DECLINED, LONG BEFORE THIS SUMMER'S UPSURGE IN MORTGAGE RATES.) THIS DECLINE COULD CONTINUE THROUGH MOST OF 1974, BRINGING ABOUT A DROP IN RESIDENTIAL-CONSTRUCTION SPENDING FROM ROUGHLY \$59 BILLION THIS YEAR TO ABOUT \$54 BILLION IN 1974.

ANOTHER TROUBLE SPOT IS CONSUMER SPENDING, ESPECIALLY IN VIEW OF THE RECENT SHARP WORSENING OF CONSUMER SENTIMENT BECAUSE OF INFLATION AND OTHER FEARS. THIS DEVELOPMENT BODES NO GOOD FOR HOUSEHOLD SPENDING, ESPECIALLY FOR DISCRETIONARY ITEMS SUCH AS AUTOS AND HOME APPLIANCES. CONSEQUENTLY, TOTAL SPENDING FOR CONSUMER DURABLE GOODS NEXT YEAR MAY BE LITTLE IF ANY HIGHER THAN THIS YEAR'S TOTAL OF \$133 BILLION. THE DECLINING TREND OF HOME BUILDING SHOULD REFLECT ITSELF IN LOWER PURCHASES OF HOUSEHOLD DURABLES, WHILE RISING PRICES AND ENERGY SHORTAGES SHOULD MOTIVATE CONSUMERS TO BUY FEWER (AND SMALLER) CARS IN 1974. IN THE QUANTITATIVELY MORE SIGNIFICANT AREA OF NONDURABLE GOODS AND SERVICES, SPENDING COULD RISE SHARPLY, FROM \$671 BILLION TO ABOUT \$737 BILLION, BETWEEN 1973 AND 1974; HOWEVER, RISING PRICES FOR FOOD, APPAREL, GASOLINE AND OTHER NECESSITIES PROBABLY WILL ACCOUNT FOR A LARGE SHARE OF THIS SPENDING INCREASE.

SEVERAL STRONG PLUSES ALSO SHOW UP IN THE OUTLOOK -- IN PARTICULAR, THE CONTINUED ADVANCE IN BUSINESS OUTLAYS FOR PLANT AND EQUIPMENT. SPENDING OF THIS TYPE SHOULD RISE FROM ABOUT \$137 BILLION THIS YEAR TO \$149 BILLION IN 1974. MUCH OF THE STIMULUS WILL COME FROM THE NATION'S NEED FOR NEW CAPACITY, TO ENSURE THAT THE SHORTAGES NOW BESETTING THE ECONOMY DO NOT CONTINUE. (THIS MEANS THAT THE DEMAND FOR NEW FACTORIES AND OTHER BUSINESS STRUCTURES MAY BE EVEN STRONGER THAN THE DEMAND FOR NEW EQUIPMENT.) FURTHER

STIMULUS WILL COME FROM THE SPENDING INCREASES MANDATED BY VARIOUS ENVIRONMENTAL LAWS AND REGULATIONS.

NEXT, WE'LL PROBABLY SEE A CONTINUATION OF A RECENT DEVELOPMENT -- THE RECOVERY OF INVENTORY SPENDING TO A MORE NORMAL LEVEL AFTER A PROLONGED PERIOD OF INORDINATELY LOW STOCKBUILDING. THE NET CHANGE IN BUSINESS INVENTORIES SHOULD RISE FROM ABOUT \$7 BILLION THIS YEAR, TO AROUND \$9 1/2 BILLION IN 1974. SOME OF THIS BUILDUP PROBABLY WILL BE UNINTENDED; FOR EXAMPLE, AUTO SHOWROOMS MAY BECOME OVERCROWDED WITH GAS-GUZZLING STANDARD-SIZED MODELS IN THE WAKE OF GASOLINE SHORTAGES. MOST OF THE EXPANSION, HOWEVER, MAY SIMPLY REPRESENT A DELIBERATE ATTEMPT TO REBUILD LONG-DEPLETED STOCKS OF GOODS.

FINALLY, THE EXPORT BOOM SHOULD CONTINUE TO PROVIDE A SUBSTANTIAL BOOST TO PRODUCTION INDEXES AND TO OUR BALANCE OF PAYMENTS. DEVALUATION AND THE IMPROVING COMPETITIVE POSITION OF AMERICAN PRODUCTS MEAN FATTER ORDERBOOKS FOR FARMERS AND FOR INDUSTRIAL PRODUCERS AS WELL. ON THE OTHER HAND, SPENDING FOR IMPORTS ALSO SHOULD RISE, MOSTLY REFLECTING THE HIGHER PRICES OF FOREIGN GOODS, RATHER THAN "REAL" SPENDING INCREASES. EVEN SO, OUR NET EXPORT BALANCE SHOULD CONTINUE TO MOVE INTO THE PLUS COLUMN -- IN CONTRAST TO LAST YEAR'S DEFICIT -- WITH A RISE FROM +\$3 BILLION TO +\$7 BILLION BETWEEN THIS YEAR AND NEXT.

THE NATIONAL ECONOMY THUS WILL BE BUFFETED BY STRONG CROSSWINDS DURING 1974, LEADING ON BALANCE TO A SITUATION

OF SLOWER GROWTH AND STILL RISING PRICES. HOW WILL ALL THIS AFFECT ARIZONA? THE OUTLOOK IS FOR REDUCED GROWTH -- BUT IN ARIZONA TERMS, THIS STILL MEANS A HEALTHY EXPANSION. TOTAL STATE INCOME SHOULD APPROACH \$10 1/2 BILLION IN 1974 AFTER RISING SHARPLY TO ABOUT \$9 1/2 BILLION THIS YEAR.

HOME BUILDING ACTIVITY PROBABLY WILL WEAKEN HERE AS ELSEWHERE, BUT THIS SLOWDOWN IS UNDERSTANDABLE, SINCE PERMIT ACTIVITY DOUBLED BETWEEN 1970 AND 1972. INDEED, THE STATE'S INCREASINGLY DIVERSIFIED ECONOMY SHOULD GENERATE FORCES OFF-SETTING ANY WEAKNESS IN THE CONSTRUCTION SECTOR. MANUFACTURING (NOW THE STATE'S LEADING INCOME PRODUCER), CATTLE RAISING, AND TOURISM ALL APPEAR TO BE SOURCES OF STRENGTH ON THE 1974 SCENE. THUS, IN TERMS OF ECONOMIC GROWTH, ARIZONA SHOULD CONTINUE TO OUTPACE THE REST OF THE NATION BY A WIDE MARGIN.

POLICY PROBLEMS

NOW, GIVEN THE PARAMETERS THAT I'VE ALREADY LAID OUT, WHAT KIND OF NATIONAL ECONOMIC POLICY CAN WE EXPECT IN 1974? THE ANSWER WOULD BE EASY IF WE WERE MOVING INTO A NORMAL CYCLICAL SLOWDOWN. THE SEVERITY OF THE PRESENT INFLATION, HOWEVER, MAKES THIS A SOMEWHAT ABNORMAL SITUATION, AND MAKES POLICY DECISIONS EXCEEDINGLY DIFFICULT.

ONE THING WE CAN BE CERTAIN OF: TIGHT WAGE AND PRICE CONTROLS ARE UNLIKELY TO BE PART OF THE POLICY PACKAGE. FOR ONE REASON, CONTROLS APPEAR TO HAVE LOST ALL OF THEIR

OLD POLITICAL GLAMOR. THERE'S NOT MUCH MILEAGE LEFT IN POLICIES WHICH HAVE BEEN SEVERELY CRITIZED BY BOTH THE AFL-CIO AND THE JOINT MEMBERSHIP OF THE NATIONAL ASSOCIATION OF MANUFACTURERS AND THE U.S. CHAMBER OF COMMERCE.

MORE IMPORTANTLY, CONTROLS DURING 1973 HAVE BEEN COUNTER-PRODUCTIVE IN FAR TOO MANY CASES, GENERATING MATERIALS SHORTAGES AND PRICE UPHEAVALS. (THIS SITUATION DIFFERS STRIKINGLY FROM OUR EXPERIENCE TWO YEARS AGO, WHEN CONTROLS APPARENTLY WORKED VERY WELL BECAUSE OF SUBSTANTIAL UNUSED RESOURCES THROUGHOUT THE ECONOMY.) EVEN SO, THERE IS STILL ROOM FOR SOME TYPE OF INCOMES POLICY IN OUR FUTURE. INDEED, AS ARTHUR BURNS HAS ARGUED, IN THE LONG-RUN WE'LL PROBABLY NEED SOME SORT OF REVIEW BOARD TO OVERSEE WAGE AND PRICE DECISIONS IN KEY INDUSTRIES WHERE COMPETITION IS INADEQUATE. TODAY, HOWEVER, WE NEED TO MOVE TOWARD THE ELIMINATION OF MANDATORY CONTROLS IN THOSE AREAS WHERE COMPETITION IN THE MARKET PLACE IS REASONABLY EFFECTIVE IN REGULATING PRICES AND ALLOCATING RESOURCES.

FISCAL POLICY IS RELATIVELY NEUTRAL IN THE PRESENT SITUATION. THIS IS A GREAT DEAL MORE THAN CAN BE SAID FOR ITS BEHAVIOR IN THE LAST SEVERAL YEARS, WHEN A SERIES OF RECORD PEACE TIME DEFICITS, AMOUNTING TO OVER \$60 BILLION IN ALL, OVERSTIMULATED THE ECONOMY DURING THE FISCAL 1971-73 PERIOD.

THE ADMINISTRATION ESTIMATES THAT THE FEDERAL BUDGET IN THE CURRENT FISCAL YEAR WILL BE BALANCED AT SPENDING AND

REVENUE LEVELS OF ABOUT \$270 BILLION. THIS BALANCE REPRESENTS THE ADMINISTRATION'S RETURN TO WHAT GEORGE SHULTZ CALLS "THE OLD-TIME RELIGION". SIGNS OF "RELIGIOUS" REVIVAL ALSO HAVE APPEARED IN CONGRESS WITH MOVES TO ESTABLISH NEW BUDGET PROCEDURES. UNDER THE PROPOSED SYSTEM, CONGRESS WOULD ESTABLISH AN OVERALL BUDGET CEILING EACH YEAR, AND THEN SLASH APPROPRIATIONS IF THE OVERALL TOTAL OF MAJOR SPENDING BILLS EXCEEDED THAT CEILING.

DESPITE THESE LAUDABLE ATTEMPTS AT REFORM, IT WILL TAKE A REAL EFFORT TO ACHIEVE THE GOAL OF A BALANCED BUDGET THIS FISCAL YEAR. ON THE SPENDING SIDE ALONE, A NUMBER OF DEVELOPMENTS COULD UPSET THIS PROJECTED BALANCE AS TIME GOES ON. THESE ITEMS INCLUDE INCREASED MILITARY SPENDING RELATED TO THE MIDDLE EAST CRISIS, LARGER-THAN-EXPECTED INTEREST PAYMENTS ON THE FEDERAL DEBT, AND A POSSIBLE ACCELERATION IN SOCIAL-SECURITY BENEFIT INCREASES.

MONETARY POLICY IS FACED WITH A NUMBER OF DIFFICULT TASKS. WE MUST ACT TO CONTAIN INFLATION IN 1974 WITHOUT CREATING A RECESSION. AT THE SAME TIME, WE MUST REALIZE THAT OUR CURRENT INFLATION PROBLEM IS NOT COMPLETELY AMENABLE TO USUAL POLICY CONTROLS -- FOR EXAMPLE, IN THE AREA OF AGRICULTURAL SUPPLY.

AS FOR 1973, IT WILL GO DOWN IN HISTORY AS A YEAR OF TIGHTNESS WITHOUT CRUNCH. MANY OBSERVERS HAVE IGNORED THE IMPORTANCE OF THIS ACHIEVEMENT BECAUSE THEY TEND TO CONFUSE HIGH INTEREST RATES WITH A CREDIT CRUNCH. A CRUNCH, HOWEVER,

IS A CONDITION WHERE FUNDS ARE NOT AVAILABLE AT ANY PRICE TO MANY BORROWERS -- AND THIS HAS NOT BEEN TRUE IN 1973. THE YEAR'S HIGH INTEREST RATES HAVE MERELY SERVED AS A WAY OF RATIONING AVAILABLE FUNDS TO BUSINESS AND OTHER BORROWERS.

REGULATION Q IS THE KEY TO UNDERSTANDING THIS DISTINCTION. IN 1966 AND AGAIN IN 1969, BANKS SUFFERED SEVERE DISINTER-MEDIATION WHEN MARKET RATES EXCEEDED REG Q CEILINGS, AND THUS THEY WERE FORCED TO CUT OFF MANY OF THEIR LOAN CUSTOMERS. IN 1973, THE SUSPENSION OF REG Q CEILINGS ON LARGE CD'S ENABLED BANKS TO COMPETE FOR FUNDS, AND THUS ELIMINATED A MAJOR SOURCE OF A POSSIBLE CREDIT CRUNCH.

THE FED WILL OF COURSE KEEP ITS OPTIONS OPEN AS IT MOVES INTO 1974. IN THE RECENT PAST POLICY HAS BEEN MODERATELY RESTRICTIVE IN THE FACE OF A CONTINUED INFLATION. AS EVIDENCE, GROWTH IN THE MONEY SUPPLY WAS PRACTICALLY FLAT DURING THE THIRD QUARTER, IN CONTRAST TO A 6-PERCENT ANNUAL RATE OF GROWTH DURING THE FIRST HALF OF 1973. TO COOL OFF THE HYPERACTIVE ECONOMY, THE SYSTEM OVER TIME HAS TIGHTENED UP ALL OF ITS MAJOR POLICY WEAPONS -- OPEN-MARKET OPERATIONS, RESERVE REQUIREMENTS, DISCOUNT RATES, AND STOCK MARGIN REQUIREMENTS -- IN ADDITION TO SUSPENDING REG Q CEILINGS ON LARGE CD'S. BUT NOW, IN THE WAKE OF FIRST STIMULATING A STRONG RECOVERY AND THEN CURBING AN INFLATIONARY BOOM, THE FED STANDS READY TO SUPPORT A STEADY EXPANSION IN LINE WITH THE LONG-TERM GROWTH TREND OF THE NATIONAL ECONOMY.

WHAT ABOUT INTEREST RATES? WELL, AS YOU MAY HAVE NOTICED,

THERE'S BEEN SOME MOVEMENT IN RATES LATELY, TO PUT IT MILDLY. ROUGHLY SPEAKING, LONG-TERM RATES HAVE DROPPED ABOUT 50 TO 100 BASIS POINTS, AND SHORT-TERM RATES ABOUT 100 TO 200 BASIS POINTS, WITHIN THE LAST MONTH OR TWO. BUT THERE HAS BEEN A GREAT MISUNDERSTANDING ABOUT THE ROLE OF THE MONETARY AUTHORITIES IN THIS SITUATION. MANY OBSERVERS HAVE BEEN WATCHING THE FED WHEN THEY SHOULD HAVE BEEN WATCHING THE BUSINESS CYCLE.

INTEREST RATES, AS THE PRICE OF MONEY, ARE DETERMINED NOT ONLY BY THE SUPPLY OF FUNDS MADE AVAILABLE BY THE FED, BUT ALSO BY THE DEMAND FOR FUNDS DETERMINED BY VARIOUS SECTORS OF THE ECONOMY. THIS DEMAND CAN BE BROKEN INTO TWO COMPONENTS -- A BUSINESS-CYCLE ELEMENT AND AN INFLATION-EXPECTATIONS ELEMENT. WITH ANY EASING OF CYCLICAL CONDITIONS, OR ANY EASING OF INFLATIONARY FEARS, WE WOULD NORMALLY EXPECT TO SEE A DECLINE IN INTEREST RATES. BOTH THESE FACTORS WERE PRESENT TO SOME EXTENT IN THE RATE DECLINES OF THE PAST SEVERAL MONTHS.

SUMMARY AND CONCLUSION

IN SUMMARY, 1974 WILL BE A DIFFICULT YEAR IN MANY RESPECTS, PARTLY BECAUSE OF POLITICAL UNCERTAINTIES, BUT ALSO BECAUSE OF THE DIFFICULTY OF SHIFTING FROM A BOOM TO A PERIOD OF SUSTAINABLE GROWTH AND DECELERATING INFLATION. OUR RECENT BUSINESS-CYCLE

HISTORY SUGGESTS THE DIFFICULTY OF ACCOMPLISHING SUCH A FEAT WITHOUT CAUSING A RECESSION, BUT THIS IS NO REASON FOR DESPAIR. INDEED, SUBSTANTIAL STRENGTH IS EVIDENT IN CERTAIN KEY SECTORS OF THE ECONOMY, SUCH AS PLANT-EQUIPMENT SPENDING, INVENTORY SPENDING AND THE EXPORTS.

FLEXIBILITY MUST BE THE BASIS OF OUR POLICY RESPONSE, GIVEN THE MANY UNCERTAINTIES WE NOW FACE. THE UNIQUE FLEXIBILITY OF MONETARY POLICY SHOULD BE HELPFUL IN THIS REGARD, HOWEVER, WITHOUT SIMILAR FLEXIBILITY IN FISCAL POLICY, WE ARE BOUND TO ENCOUNTER CONTINUED PROBLEMS IN OUR ATTEMPT TO CONTROL THE UPS AND DOWNS OF THE BUSINESS CYCLE.
