THE ECONOMY IN 1975

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These are difficult times for all of us, as the economy begins to emerge from the longest and most severe recession in nearly forty years. The American public is in a nostalgic mood these days, which may account for the heightened interest in the Great Depression among the young. But to those of us who lived through the troubled days of the 1930's, they are times to be read about rather than relived. One should feel no sense of deprivation at not having been a participant in what can justly be described as the "bad old days."

The headlines in the past couple of weeks have truly been a mixed bag of bad news and good news. The bad news is that real economic output in the first quarter fell at the fastest rate since 1938, reflecting a massive liquidation of inventories. The good news is that the rate of price inflation declined from about 11½ percent to 7 percent between the last quarter of 1974 and the first quarter of 1975. While 7 percent is still unacceptable as a long-run inflation rate, it is evident that significant progress has finally been made in the hard struggle against inflation.

The substantial reduction of inventories is actually a favorable development. The large overhang of stocks built up last year has recently been depressing both production and employment. As these excessive inventories are worked down, the renewed inflow of new orders should stimulate an expansion in production and thereby a recall of furloughed workers.

The Business Outlook

We have probably put the worst of the recession behind us. Most observers expect a recovery to get underway this summer, and I see no reason to quarrel with this view. My own research staff expects gross national product to rise by 7 or 8 percent this year, in current-dollar terms, to the neighborhood of $1.5 trillion. However, when allowance is made for price increase, physical output will probably be almost 4 percent below the average level of 1974. This will be true despite a drop in the inflation rate from 11½ percent at the end of last year to probably less than 6 percent by the end of this year.

One dark cloud remains on the horizon. The Council of Economic Advisors expects the unemployment rate to remain high -- in the 7-to-9 percent range -- through the 1975-78 period. There have been dramatic shifts in the age composition of the labor force, with the post-World War II baby-boom generation now growing to adulthood and looking for work. Thus, the labor market is being called upon to absorb massive numbers of new young workers at a time of recovery from recession. For that matter, unemployment does not usually recede until well after the turn in the cycle. Productivity is highest in the early stages of a recovery, and business generally lengthens the work week and pays overtime before beginning to hire new workers on a large scale.

How will we get out of the recession? This has been a most unusual downturn, because it was caused in large measure by the consumer and its cure will largely depend on improved consumer confidence. Willful perversity on the part of consumers did not bring us to our present pass;

it was simply a matter of prices rising faster than incomes and eroding the purchasing power of consumer income. After-tax income, adjusted for prices, fell 3 percent last year. But now, the twin effects of a declining rate of inflation and a smaller tax bite should turn consumer spending around by mid-summer. The current massive inventory correction will give way to a modest restocking of shelves. The other part of the tax cut, the investment tax-credit, when added to the quickening pace of consumer demand, should encourage businessmen to expand capital spending. If we have written the proper script, the economy can return to a healthy 4-to-6 percent rate of growth of real GNP in late 1975 and 1976.

Tax Cuts and Tax Increases

Now, this week will be fairly memorable, for this is when the first checks of the $8 billion of 1974 tax rebates will be put into the mail. Even more dollars -- $8 billion at an annual rate -- will show up in our take-home pay this month as lower withholding schedules become effective. In addition, about $5 billion of tax relief will be going to business. This massive tax cut is one of the most potent fiscal weapons available in the fight against recession. Less obvious is the fact that the tax reduction simply serves to offset *de facto* increases in taxes which were not imposed by Congress.

The first of these "taxes" was the quadrupling of Persian Gulf crude-oil prices by the OPEC oil cartel. When we look at what this did to the price of gasoline and other petroleum products, we consider this oil-price increase to be inflationary. However, the increase also had a major deflationary impact, since the burden on American consumers was roughly equivalent to a 10-percent increase in personal income taxes. As the price boost works its way through the economic system, it depresses real income at home and thereby forces the release of real resources for the benefit of oil-producing countries. This is analogous to a capital levy, such as the war reparations that the Germans exacted from the French after the Franco-Prussian War of the 1870's, or what the French in their turn demanded of the Germans after World War I.

The adjustment to the change in oil prices has afforded us a vivid, if painful, textbook exercise in the workings of supply-and-demand forces in the market. The energy demand of public utilities was flat in 1974, in marked contrast to the normal 5-to-10 percent annual increase. Gasoline consumption was below the projected rate of growth, and two mild winters in a row reduced heating demand. The worldwide recession itself reduced oil consumption, and OPEC producers have slashed output by 11 million barrels per day in their attempts to maintain prices. Shipping rates have tumbled and -- strange as it may seem -- the world's major parking problem today is finding places to lay up redundant supertankers.

An even larger "tax" has been imposed by domestic inflation. Make no mistake about it; inflation is a tax, and it reaches into your pocket every bit as effectively as the more conventional efforts of the Internal Revenue Service. One direct effect of inflation is to increase our effective tax as higher incomes push us into higher marginal brackets. It has been estimated that wage and price increases in recent years have increased the effective rates in all tax brackets by more than 3 percent. Furthermore, corporate taxes are much higher than Congress ever intended, because inflation is not taken into account when calculating depreciation and inventory profits.

We have already made some progress in dealing with the inflation problem, although we've been operating with an inadequate yardstick in recent years. The price indexes have been somewhat misleading because of the effect of price controls. The controls of the 1971-73 period concealed inflationary pressures in the form of shortages and quality deterioration. Then, when controls were lifted, the concealed price increases came out into the open and forced the indexes to overstate the actual increases of 1973-74. In addition, the indexes included certain superficial increases that many firms posted for the purpose of making a record, just in case controls should ever be reinstated.

The 1973-74 price bubble also reflected the after-effects of dollar devaluation, plus the impact of a number of worldwide shortages: weather-caused in the case of food, boom-created in the case of internationally-traded industrial raw materials, and partly politically inspired in the case of oil. We are now hearing the welcome sound of bursting bubbles, and the price indexes should reflect that fact, along with the decline of inflationary expectations as the price spiral decelerates. We may also hope to see some improvement in the fight against the underlying inflation generated by the earlier prolonged period of excess demand.

The Financial Markets

Although we're now beginning to see our way out of the current recession, let me assure you that we are by no means home free. In addition to the $23 billion of tax cuts, there have been a number of other Federal programs designed to alleviate recession and unemployment. Among these are extensions of the coverage and duration of unemployment benefits and public-employment programs. These are all useful and well-intentioned programs, but they also add to the size of the Federal deficit.

The deficit for fiscal 1975, which ends next month, is now expected to total $45 billion. The Treasury currently anticipates a deficit of almost $80 billion for fiscal 1976 after the incorporation of the tax cut and recession-related legislation. Most of the funds for the tax rebate are expected to be raised in the market by the Treasury in the present quarter. For the year as a whole, the cash needs of the Treasury will approach $85 billion, by all odds a peacetime record.

A spirited debate has been going on recently regarding the Treasury's ability to raise the massive sums that it needs over the next year or so without destabilizing the financial markets. Those who believe that this tremendous financial operation can be carried out successfully point as proof to the current weakness of demand from the private sector of the economy. Certainly the demand for bank loans is down. Businesses are retiring bank borrowings, they are reducing their inventory levels, and they are funding their enormous borrowings of last year -- obtained when the banks were the only game in town -- through borrowings in the bond market. Consumers are also paying off instalment debt, and they are taking on little new debt because they are not purchasing autos or appliances. Thus, so the argument goes, the weakness of the demand for bank credit will allow the banking system to purchase a major part of the coming Treasury deficit.

The opponents of this argument concede that the Treasury will be successful in obtaining its financing needs in the financial markets. But there may be very real costs to the private sector of the economy, particularly in the early stages of the expected recovery. If the private demand for credit starts to pick up early in the recovery, the total credit demand may soon outrun supply. This will drive up interest rates and result in private borrowers being crowded out of the market. This could very well abort a recovery in the housing industry, which has been the most sorely-troubled sector of the economy during the recession -- and which has always been the first to be elbowed out of the market whenever the supply of funds becomes scarce. The adverse effects of such straitened circumstances in the financial markets could spread further and cut the recovery short of its potential expansion.

What of the Federal Reserve?

The Federal Reserve will be a very interested party to the Treasury's financing needs over the next year. For a decade now, the Fed has been called upon time and again to ensure the successful funding of Treasury deficits, in periods of rapid economic expansion as well as in times of recession. A convincing case may be made for monetary ease to finance Treasury deficits in this recession, since demand is weak in the private sector and the risks of promoting or exacerbating inflation are smaller. Thus, credit policy has been eased in recent months, with a fall in short-term interest rates and a restoration in the liquidity of the banking system. Should any of you wish to borrow from your friendly neighborhood banker, I'm certain that you will find him much more accommodating now than he was a year ago.

However, the legacy of inflation that is still with us derives from chronic Treasury deficits in times of high levels of economic activity and of strong demands for funds from the private sector. Under past budgeting procedures -- procedures which will be replaced next year -- Congress consistently kept divided the two functions of appropriating funds and providing revenues. All too often, it legislated new programs without either supplanting outmoded programs or raising newly required revenues through taxation. Consequently, the Federal Reserve often became an unwilling partner in financing the resulting deficits.

The Short Run and the Long Run

In the present circumstance of a protracted decline in real output and a high level of unemployment, an easier fiscal and monetary policy is altogether appropriate. Still, the Federal Reserve is concerned about the effects upon financial markets of a deficit that could conceivably approach $100 billion in the absence of Congressional restraints upon Federal spending. In earlier recessions, the Fed ensured the successful financing of large Treasury deficits in more-or-less routine fashion, but this time, there are significant differences from our earlier experiences.

First of all, we entered this recession with the highest rate of peacetime price inflation in our history. We welcome the recent decline in the inflation rate, but we cannot count on continued decreases of this magnitude. Borrowers must borrow more in times of inflation because prices are higher and are expected to continue to rise. Thus, while the demand for credit from the private sector of the economy may be weaker than before, it is by no means inconsequential. The Treasury still faces significant competition for funds.

Again, as the economy enters a period of sustained recovery, the private demand for credit will grow as business rebuilds depleted inventories and seeks to borrow funds for capital expansion. The inflationary potential in this situation could be minimized only if the Treasury's demands for funds decline.

Some observers suggest that the Federal Reserve should provide whatever rate of growth in money and credit is required to ensure that <u>all</u> borrowing requirements--Federal and private--are met at stable or declining rates of interest. Because of the lagged impact of monetary policy upon prices and interest rates, the inflationary effects of such a broad guarantee of accommodation to all borrowers would not show up immediately, but a year or two hence after the recovery gets underway. Congress did not address itself to this question when it passed the tax-cut bill, but it must face up to the problem as it handles forthcoming appropriation bills, if it ever wants to get inflation under control.

Looking further down the road, the economy's capital requirements appear to be well-nigh insatiable. The development of new energy sources could easily absorb $1 trillion, without regard to the sums necessary for pollution control, urban transportation, or the rebuilding and expansion of basic industries. It should be emphasized that capital formation is the major source of job creation over the long haul. Yet the inflation of the past decade has increased business taxation and reduced the rate of profitability, greatly eroding the incentives for capital formation. The recent tax bill included almost $5 billion of tax relief for businesses through an increase in the investment tax-credit from 7 to 10 percent -- 4 to 10 percent for utilities. But there was no action to reduce the basic corporate-tax rate from 48 to 42 percent, as proposed by the Administration.

The large profits reported by corporations over the past decade were largely illusory. After adjusting for the effects of inflation upon inventory costs and the replacement value of depreciated equipment, corporate profits declined by 50 percent rather than rising by over 70 percent (as reported) between 1965 and 1974. Obviously, with the internal cash flow of corporations being squeezed, businesses must look to the capital markets for funds -- and if severe inflation were to resume, the ability of the capital markets to function, much less meet the demands for funds, would be a matter of serious question.

Concluding Remarks

To sum up, 1975 is one of those years where patience is essential, as the economy makes a painful adjustment to the inflationary excesses of the past decade. The saving grace of recessions is that they bear within themselves the seeds of recovery--in this case, a return to non-inflationary growth with full employment. The starting point in the recovery is a sharp improvement in the condition of consumers' after-tax income. The tax cut will help here, and it will be more than reinforced by the deceleration in prices; with a $1-trillion consumer economy, a 2-percent reduction in the rate of price inflation is roughly equivalent to the total increase in take-home pay through tax reductions.

While the Federal Reserve is totally sympathetic to the present problems of the recession, we are also concerned about preventing the coming recovery from degenerating into yet another inflationary boom. This can be achieved through a two-fold approach. Much emphasis must be placed on job-creating capital formation, which requires the development of a proper tax structure and the viability of capital markets as the means of providing the necessary internal and external access to capital funds. At the same time, long-run price stability requires that the fiscal stimulus needed for recovery does not sow the seeds of another price explosion down the line. If new Federal spending programs are not held in check, we face the prospect of triple-digit deficits breeding continued double-digit inflation.

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