ECONOMIC & FINANCIAL MARKETS IN 1975

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It's a pleasure to meet with our Los Angeles directors and friends outside our usual haunts at Olive and Olympic Streets. Meeting as we are here in Bakersfield serves to emphasize the diversity and strengths of the California economy. In terms of gross product, California by itself ranks among the top ten nation-states in the world, and one of the reasons for its high ranking is the state's strong agribusiness industry. According to the latest Census of Agriculture, California leads all other states in the value of farm products sold. Kern County, with its cotton and other products, of course is a major contributor to the state's performance. I understand too that Bakersfield has another reason to be proud--its reputation as the new home of country and western music.

Now let's look at some good news and some bad news--the record of the national economy. The bad news is that real economic output in the first quarter fell at the fastest rate since 1938 on the heels of a massive liquidation of inventories. The good news is that the rate of price inflation declined from about 14½ percent to 8½ percent between the last quarter of 1974 and the first quarter of 1975. While 8½ percent is still unacceptable as a long-run inflation rate, it's evident that significant progress has finally been made in the hard struggle against inflation.

The Business Outlook

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.

In fact, 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. I'm impressed by the March turnaround in the index of leading business indicators, and especially by April's record increase in that useful indicator of future business conditions.

As for the basic statistics, my 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 rising prices, 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 14½ percent at the end of last year to probably less than 6 percent by the end of this year. At the same time, we'll be left with one difficult problem--an unemployment rate that might range as high as 8 to 9 percent for the next several years.

How will we get out of the recession? A great deal will 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 both consumer purchasing power and consumer confidence. 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 midsummer. 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 their spending for new plant and equipment--a sector which has recently been weakening. 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.

The California Scene

California's situation merits special attention for, as I mentioned, apt comparisons of the California economy should be made with other nations rather than with other states of the union. But a large-scale economy is often accompanied by large-scale problems, such as a 10-percent unemployment rate. This situation has been caused in part by the current recession and, more than that, by the structural problems of aerospace and other "growth" industries which are no longer growing. The aerospace industry typifies the state's problems in this respect. Recent job losses have totalled about 30 thousand, as weaknesses have developed in the commercial-aircraft and electronics segments of the industry. Still, the recession has been steeper in the heavy-manufacturing states of the Midwest than it has been here. As a result, the gap between the California and the national unemployment rates has narrowed from 2 percentage points to 1 percentage point over the past year.

Another structural weakness of California in the 1970's has been the sharp deceleration of population growth--in the past, a consistently strong support for construction and other industries. The increase in births is no greater now than it was in 1950, although we might expect it to be twice as large because the total population is twice as large today. In addition, the increase from migration is only a fraction of what it was during the long boom of the 1950's and 60's.

Nonetheless, California's basic situation still appears favorable. As I said, the present recession has been much steeper in the rest of the nation, despite our higher unemployment rate. The aerospace industry is holding up relatively well because of rising defense and space spending as well as a continued high level of foreign sales. Homebuilding, here as nationally, should recover from its current slump as the improved flow of funds into mortgage-lending institutions is translated into bricks and mortar.

Finally, the state's incomparable agribusiness industry should provide a basic source of strength throughout this decade, stimulated by the bargain-basement prices offered abroad because of the devaluation of the dollar. California's farm cash receipts may be off slightly this year because of the world-wide slump in demand and improved crop prospects abroad, but they should still be almost double pre-1972 levels. Because of all of these factors, I would expect the massive California economy to generate over $135 billion in personal income this year, for an 8-percent gain over the 1974 level.

Tax Cuts and Tax Increases

By now you should have received--and perhaps spent--your share of the $8-billion 1974 tax rebate. In addition, $8 billion more at an annual rate is showing up in your take-home pay this month as lower withholding schedules become effective. Besides, 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.

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 an increase in effective taxes as higher incomes push us into higher marginal brackets. According to some estimates, this has meant at least a 3-percent rise in effective income-tax rates in all tax brackets. Furthermore, corporate taxes are much higher than Congress ever intended because inflation is not taken into account when calculating depreciation and inventory profits.

The Financial Markets

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

The Treasury expects a deficit of $43 billion in fiscal 1975, which ends this month. The latest official forecast for fiscal 1976 is $60 billion, but there is growing uncertainty whether Congress will go along with the President's proposals for spending hold-downs, and whether it will add on new recession-related expenditures to push the deficit to $69 billion or even more. In any event, the Treasury's total cash needs in calendar 1975 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. Many observers believe that this tremendous financial operation can be carried out successfully, pointing 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. Besides, consumers are paying off instalment debt, and they are taking on little new debt because of a lack of interest in new cars 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 what it needs in the financial markets. But there may be very real costs to the private sector of the economy. 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. Among other consequences, there could be an abortive recovery in the housing industry, which has been the most sorely-troubled sector of the economy during this 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.

The Short Run Outlook

Under present circumstances--a protracted decline in real output along with high and rising unemployment--a Treasury deficit and an easier monetary policy are altogether appropriate. Still, the Federal Reserve is concerned about the possible long-run effects upon the financial markets of a massive Federal deficit that could be boosted even more by new spending programs. In earlier recessions, the Fed ensured the successful financing of large Treasury deficits in more-or-less routine fashion, but this time, we're finding significant differences from our earlier experiences.

Mr. Meany of the AFL-CIO has suggested that the Administration deliberately run a $100-billion deficit in order to head off an unemployment rate that (he thinks) will approach 11.5 percent. As a justification for this all-out pump-priming effort, he argues that every percentage-point reduction in the unemployment rate increases Federal revenues or reduces recession-related expenditures by $16 billion--which is true, but not the whole story. We must also keep in mind a financial fact of life noted by Treasury Secretary Simon; that is, the recession may be just about 75-percent over, but the Treasury's borrowings to finance the deficit are only about 25-percent completed. This situation could lead to a serious overlap, with the credit demands of the private sector reviving as the economy recovers, but with the cash needs of the Treasury continuing undiminished.

The Federal Reserve is concerned that the massive incursions of the

Treasury into the money markets will result in a resumption of severe inflation. As the economy enters a period of sustained recovery, the private demands 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 enough growth in money and credit flows to ensure that all borrowing requirements--Federal and private--are met at stable or declining rates of interest. But history tells us that such a broad guarantee of accommodation to all borrowers would have definite inflationary consequences--not immediately, but a year or two hence. Our experience of recent decades has shown that the "good news" from excessive monetary stimulus appears first, with production and employment expanding within perhaps six to twelve months of the initial stimulus. However, the "bad news" comes later, in the form of increased inflation with a lag of perhaps one to three years. For this reason, Chairman Burns told the Senate Banking Committee last month that the Federal Reserve has set a target of 5-to-7½ percent in the money stock through March of next year--the maximum now considered to be a non-inflationary expansion in the context of the current economic outlook. Even the higher end of this range may not be sufficient to accommodate all prospective borrowers if the budget deficit is allowed to rise to $70-80 billion or higher.

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 appropriations bills, if it is to be successful in controlling inflation. The current recession is essentially a reaction to the excesses and distortions of the preceding inflation. It's a losing proposition to adopt monetary and fiscal programs which provide excessive stimulation to the economy and inevitably generate more inflation.

A hopeful sign in this regard is the implementation of the Budget Control Act adopted last year. Hitherto, the Federal budget process was quite deficient, with spending decisions handled in piecemeal fashion, and with spending plans kept separate from revenue plans. Now Congress is beginning to integrate these two types of decisions, and if the proper follow-through is achieved, we can expect a much healthier economic environment in the long run. Unfortunately, we're faced with an immediate problem. The two Congressional budget committees have recommended spending and revenue targets for fiscal 1976, but those recommendations are not binding this year, since the full budget-reform process will not be effective until fiscal 1977. It is Congress' current actions that will provide the crucial make-or-break decisions for financial markets in the coming year.

The Longer-Term Problem

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 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. But 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.

The recent tax bill included only a minimal amount of business-tax relief. Specifically, about $5 billion of such relief was provided through an increase in the investment-tax credit from 7 to 10 percent, or from 4 to 10 percent for utilities. But there was no action to reduce the basic corporate-tax rate from 48 to 42 percent, or other such measures, as proposed by the Administration. The recent tax bill was aimed principally at the short-term goal of stimulating consumption as an anti-recession measure. But over the longer run, we need a basic reform of business taxation to obtain the volume of capital formation necessary for vigorous economic growth.

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--that is, 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 determined to combat the recession, it is also concerned about preventing the coming recovery from degenerating into yet another inflationary boom. First, increased emphasis must be placed on creating jobs through capital formation. This means that we must develop a proper tax structure and keep the capital markets viable in order to provide the necessary 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. This means that Congress should closely abide by the spirit of the new Budget Control Act. Indeed, if new Federal spending programs are not held in check, we face the prospect of triple-digit deficits breeding renewed double-digit inflation.

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