THE ECONOMY IN 1974

REMARKS BY

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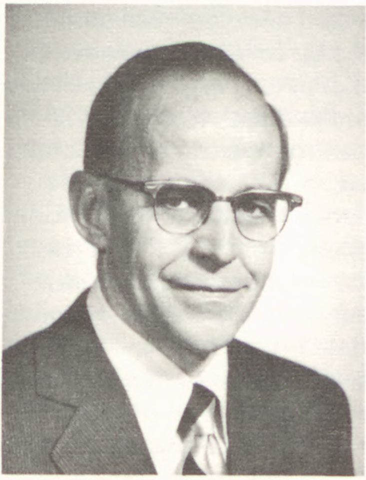

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I am glad to have the opportunity to share with you my thoughts about the business outlook. The times ahead may be difficult, but they should be less trying if we understand just where we are and plot our course accordingly.

A number of things have gone wrong with the U.S. economy during the past several years, but I would be remiss if I failed to point out that a number of things have also gone right during this phenomenal boom period. The economy has grown almost 14 percent in size, in real terms, since the New Economic Policy burst on the scene in August 1971. The number of workers in our factories, offices and farms has increased over 8 percent—the greatest accomplishment in this respect since the postwar 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.

But the overall record of accomplishment has been badly marred by an inflation problem that has left most of us groping for descriptive adjectives. Part of the inflation problem is beyond human control. We can't do much about the fact that, in 1972, the worldwide grain crop declined for the first time in modern history, causing mammoth food shortages abroad. Part of the inflation problem also is largely beyond the control of domestic policy-makers. We can't do much about the fact that, in 1973, all of the economies of the developed world boomed at the same time, placing severe pressures on industrial prices.

Worldwide demand for food and industrial commodities increased sharply in those sectors where the U.S. is the major source of supply. And with the dollar as much as 20 percent cheaper than it was several years ago, purchases of such American products took off like a rocket, rising almost 50 percent in the past year alone. This development caused a vast improvement in our balance of payments, but it also generated extra difficulties for prices on the domestic front.

Energy Crisis

As of early fall, the inflation problem appeared difficult but not insurmountable, especially in view of the lessening demand pressures that were already making themselves felt in such industries as housing and autos. But then a new development occurred—the long-expected energy crisis—partly but not entirely because of the Arab oil embargo. We should note that a shortage of refining, shipping and port capacity would probably have brought on a crisis in fairly short order even if Arab oil had remained available. As the crisis mounted in November and December, wholesale prices jumped sharply above year-ago levels—65 percent higher for the overall fuel category and 125 percent higher for refined petroleum products alone. The average price of our oil imports rose from $2.75 per barrel in the first quarter of the year to over $5.00 in November, and the situation apparently has worsened since then.

The oil shortage obviously has given us a severe setback in our struggle against inflation. The more important question, however, concerns its impact on production and employment. An embargo-created cutback in imported petroleum of 2.7 million barrels per day amounts to a shortfall of more than 14 percent from estimated petroleum demand. Only a small part of this shortfall can be made up this year by increased domestic output or by substitution of other fuels. In the short run, there are only limited possibilities for substituting fuels or altering production techniques to reduce industry's dependence on petroleum. The Administration's conservation program therefore is aimed at economizing end-product uses, especially in the consumer sector, in order to ensure adequate fuel supplies for basic industry.

Most observers expect that the embargo will be lifted sometime in the next several months, thereby easing the immediate shortage. In the meantime, we'll all have to put up with a great deal of inconvenience. We'll be getting up earlier, driving more slowly (frequently in car pools and buses), and living and working sometimes in chilly, dimly lit rooms. But inconvenience should not be equated with economic dislocation. Many industries surely will be injured by the shortage—every one of us can think of a half-dozen examples off the top of our heads—but the overall dislocation should be little if any greater than that imposed by the discipline of the market year after year.

Many adjustments, some of them too long delayed, will eventually have to be made to the long-run changes in the availability and price of energy supplies, but we can count on the resilient American economy to accomplish this with a minimum of strain. To begin with, we can expect to see a gradual increase in the domestic output of crude oil, a shift by electric utilities to greater reliance on coal, a shift by auto manufacturers to increased small-car production, and so on down the list.

National Outlook

But what does this mean for the economy in 1974? The question was difficult enough to answer prior to the onset of the crisis, because of the many uncertainties surrounding an economy that contained many weaknesses but was generally operating at the very limits of capacity. The oil shortage creates its own set of uncertainties, but its impact very likely will be felt in a faster rise of prices, and a slower growth of output and employment, than we had originally envisioned.

At this point, it might help to review some of the figures contained in the forecast prepared by my economic staff. This forecast shows gross national product rising about 8 percent in 1974 to roughly $1,391 billion, but most of that rise will be attributable to price increases rather than gains in real output. Prices are expected to rise by almost 7 percent, as compared with last year's almost 5½-percent increase. Real output is projected to increase about 1 percent for the year as a whole, after two successive years of 6 percent increases. Real output should decline in the first quarter and show little if any gain in the second quarter, but it is expected to be on a rising trend in the second half of the year. Also, with output and employment lagging, the unemployment rate should average more than 5½ percent for the year, compared with a little less than 5 percent in 1973.

In some respects, we are facing the worst of all possible worlds—a situation of rising prices, rising unemployment and sluggish output, all at the same time. The appropriate term to describe this situation is "stagflation"—an ugly word to describe an ugly condition. But it is worthwhile emphasizing that the basic outlines of the 1974 economy were set in place long before the fuel crisis came along to muddy the waters. Two other points are worth emphasizing. First, we expect the basic adjustments in the economy to be completed in the first half, so that the rate of real growth will be increasing again later in the year. Secondly, with the easing of demand pressures and gradual improvements in supply, we expect that the rate of inflation will diminish from presently high levels by year end.

A major soft spot in the economy is the housing industry. Dollar spending for new housing levelled off about a year ago, and housing starts actually peaked about two years ago, although the steepest decline occurred in the second half of 1973. Now, with the fuel shortage adding to the long-standing weakness in basic demand, the downturn in this industry could last throughout 1974, leading to a 13-percent decline in dollar spending for the year as a whole.

Another trouble spot is consumer spending, especially in view of the recent sharp worsening of consumer sentiment because of fears about inflation and shortages. This development bodes no good for such discretionary items as autos and home appliances. Moreover, the declining trend of home building should be reflected in lower purchases of household durables, while rising prices and energy shortages should motivate consumers to buy fewer (and smaller) cars in 1974. As in the case of housing, however, basic demand for autos would have been sluggish anyway because of the very high sales volume of the three preceding years.

The fuel crisis meanwhile will cut heavily into other types of discretionary spending, such as travel and recreation. Altogether, consumer spending for durables is unlikely to show any gain at all this year, after two straight years of 13-percent increases, while spending for nondurable goods and services should rise at a somewhat slower pace than usual.

In contrast, several strong pluses show up in the outlook, especially the continued advance in business outlays for plant and equipment. A strong 12-percent gain is projected for this spending item, although postponements can occur in some areas in response to shortages of fuels and other materials.

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 arise again. Further stimulus will come from the spending increases mandated by various environmental laws and regulations. In particular, the national drive for self-sufficiency in fuels should support an upsurge in capital spending not just in 1974, but throughout the next decade, leading within several years to energy-industry expenditures several times its recent level of capital spending.

In 1974 also, 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. Some of this buildup will probably be unintended, reflecting such factors as the present overcrowding of auto showrooms with gas-guzzling larger-sized cars. Most of the expansion, however, may simply represent a deliberate attempt by businessmen to rebuild long-depleted stocks of goods, as the recent massive increase in factory order backlogs works its way through the production process.

In addition, the export boom should continue to provide a boost to production indexes, but at a somewhat slower pace of advance than we have recently experienced. Because of the earlier devaluation and the improved competitive position of American products, farmers and industrial producers are still working off thick orderbooks from last year. New orders may be a little harder to come by, however, because of the recent reversal in exchange rates and the worsening of the European and Japanese economies. At the same time, spending for imports should rise steeply, mostly reflecting the upsurge in oil prices, and creating severe pressures on our balance of payments.

From what I've said up to now, you can understand that 1974 will be a problem year, with strong pluses but also with some definite minuses. The impact of all our problems will be felt on the bottom line—the average businessman's profit. Last year, pre-tax profits soared more than 30 percent to $128 billion. This year, there will probably be no gain at all in the aggregate. We will see a number of radically different profit patterns, industry by industry. A number of industries will experience substantial declines in earnings, at least in part because of the energy crisis, while the energy sector should experience a substantial surge in profits. The market, operating through the profit mechanism, will allocate a greater flow of funds to energy producers, thus providing the investment capital needed to meet the nation's long-term energy needs.

Regional Outlook

To complete this forecast picture, let me briefly review the situation here in California and the West. Personal income—the broadest measure of regional activity—should rise about 7½ percent to $177 billion for the West as a whole, with California alone accounting for about $120 billion. We can expect, here as elsewhere, some weakness in housing and auto purchases, but significant strength in business investment and agricultural production, along with the development of new energy sources. The important aerospace industry will receive some help from Federal defense purchases, but will otherwise be a neutral factor in the outlook.

The Western boom in 1973 was based mostly on heavy national and international demands for the products of Western farms, forests and mines. In some lines—forestry in particular—we will see some slackening of last year's headlong pace. In another line—agriculture—continued strength in production and exports can be expected, because of a hungry world's increasing dependence on the immensely productive Western agribusiness community. In yet another line—energy—this region is on the threshold of a massive effort to meet the national goal of self-sufficiency within a decade.

In a word, 1974 will be a year of transition for the West. Real incomes will increase only modestly. The jobless rate—already high with about 6½ percent unemployment last year—could rise perhaps to over 7 percent this year. Also, some areas will encounter major energy shortages. We must remember, however, that the West will be a major part of the solution to the energy crisis, with the development of

Alaska's North Slope bonanza, California's offshore oil deposits, and the massive resources of coal and shale oil in the mountain states.

Policy Problems

Now, given the situation as I've described it, what kind of national economic policy can we expect in 1974? The question would be difficult to answer in any case, because of the persistence of inflation during a projected economic slowdown. But with the advent of the energy crisis, with its possibly severe dislocations of supply, we are faced with a completely new situation which muddies the waters even more for the nation's policymakers. Perhaps the best we can expect is a relatively neutral policy stance during this difficult period.

One thing appears nearly certain: tight wage and price controls are not likely to be part of the policy package. For one reason, controls appear to have lost all of their old political glamour. More importantly, controls over the past year have helped generate material shortages and price upheavals in too many cases, in contrast to the 1971 situation, when they apparently worked very well because of the presence of unused resources throughout the economy. Even if Congress retains the controls program throughout 1974, we are likely to see more developments along the line of the recent auto agreement, with the Administration removing wage and price controls from individual industries in return for pledges of pricing restraint.

However, controls of another sort—supply allocations—may become widespread as a means of meeting the essential fuel requirements of basic industry. Little argument may be raised generally on that score, but a major controversy already rages over the related issue of consumer gasoline rationing. Some Congressional leaders prefer rationing to a market or fiscal solution, reasoning that any price (or tax) increase sufficient to deter consumption would be so prohibitively high as to price lower-income families out of the market.

But rationing would create its own market distortions, similar to those we have encountered in other fields over the past year or so, and it probably would also require a large (and expensive) bureaucracy to enforce. It's worthwhile remembering that the World War II Office of Price Administration required a staff of 35,000 paid workers and almost 200,000 volunteer clerks to carry out all its rationing chores.

Fiscal policy has been relatively neutral in recent months, in striking contrast to its behavior during the fiscal 1971-73 period, when it overstimulated the economy with a series of record peace-time deficits, amounting altogether to over $60 billion. Projections made last fall showed a balance in the fiscal 1974 budget at about $270 billion, but the fiscal picture (like the economic situation) has lately become more uncertain.

Revenues will rise because of the recent increase in social-security taxes, and they should also benefit from any rise in gasoline taxes, although that would not be the primary purpose of such a move. On the other hand, the ceiling on economic activity imposed by the fuel shortage will have a depressing effect on revenues, while any subsidies to affected workers or industries will boost Federal spending, adding to a list of increases which already includes higher Pentagon spending, higher social-security benefits, and higher interest payments. The probable consequences of all these developments, according to the

President's budget message yesterday, will be a $4.7-billion deficit in fiscal 1974 and a $9.4 billion deficit in fiscal 1975. However, there's some likelihood that the Federal budget could be higher than projected, since an official spokesman has indicated that, if necessary, the Administration will "bust the budget" to combat unemployment.

Monetary policy is faced with a number of difficult tasks. We must act to contain inflation in 1974 without exacerbating present economic weaknesses, gearing the growth of the money supply to a sustainable pace of business activity. At the same time, we must realize that our current inflation problem is not completely amenable to usual policy controls, especially in the crucial areas of fuel supplies and farm supplies. Our problems could be compounded by the public's fears over a continuation of the record high interest rates which characterized the 1973 economy.

But why did interest rates climb so high? Primarily because of the strength of the underlying inflation, which not only stimulated a vast expansion of credit demands, but also forced borrowers, savers and investors to add an inflationary premium to the interest rates at which they were willing to do business. Secondly, because the major share of the burden of curbing inflation was left to monetary policy, after fiscal policy had produced inflation-fueling deficits during the formative stages of the boom.

In addition, a growing share of credit restraint was achieved through the price mechanism—through higher interest rates—rather than through nonprice restraints on credit availability, such as the Federal Reserve's former interest-rate ceilings on large certificates of deposit. This increased dependence on the price mechanism can lead at times to sharp rate fluctuations, such as we've recently experienced, but it stands out as the most efficient and most equitable way of implementing monetary policy changes.

Concluding Remarks

In summary, 1974 will be a difficult year in many respects, partly because of political uncertainties and supply shortages, but also because of the problems involved in shifting from a boom to a period of sustainable growth and decelerating inflation. The task is difficult but not insurmountable.

Indeed, our task will be eased by the continued strength evident in certain key sectors of the economy—in particular, business capital spending. By the second half of the year, we can expect some improvement in the general tone of business, and at least the beginnings of a slowdown in the trend of prices.