BUSINESS, FINANCE AND POLICY IN 1978

REMARKS OF

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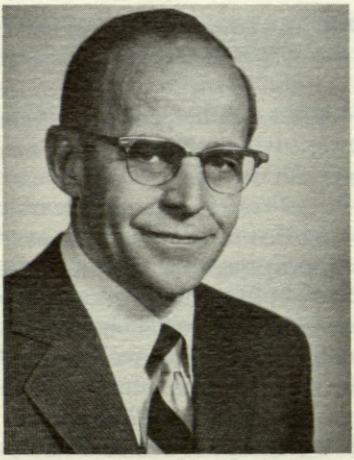

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According to Mr. Balles, 1978 should witness continued economic growth but a change in the character of the expansion, with the fast-growing sectors of the past year slowing down and the former slow-growers speeding up. The projected economic strength could yet be undermined by a number of different problems—the record deficit in our international transactions, the upsurge in energy costs, the cost squeeze in agriculture and other basic industries, the continued high level of unemployment, the severe stock-market decline, and the related weakness in business profits and business investment plans. But throughout all our problems runs a single common thread—inflation, resulting largely from a long series of Federal budget deficits which have pulled monetary policy off course in an expansionary direction. Given that context, the best monetary-policy prescription is to pursue a gradual reduction in the growth rates of the monetary aggregates, to a level consistent with long-run price stability. Continued Federal Reserve independence is essential for achieving that policy goal.

I'm delighted to join you this evening for a discussion of the 1978 business and financial outlook, but I intend to make only one unqualified forecast—namely, that the market for economists will continue to be much stronger than the market for most other things. But of course, we can always be safe in making that forecast, at least as long as the economy has ills to diagnose. As for the usefulness of our endeavors, some critics are likely to say that we'll be spending all our time next year just re-arranging the deck chairs on the Titanic. But I hope that we'll be more usefully employed—analyzing the very real problems of the economy and advising solutions that will guarantee a regime of solid growth, high employment and stable prices well into the next decade.

Economic Cross-currents

I'd like to spend most of my time this evening discussing the causes and cures of our economic difficulties, but first let me sketch the projected shape of the 1978 economy, as it appears in the usual consensus forecast. There are not too many disagreements on that score—which is to be expected, considering the profession's tendency to rely upon similar forecasting services, whether the source is Otto Eckstein, Larry Klein or even Jimmy the Greek. Thus, we begin with a general expectation of a gradual deceleration in activity, following the rapid 7-percent rate of growth of real output in the first half of 1977. Output might grow at about a 4½-percent rate in the second half of this year, and close to that same pace between late 1977 and late 1978. At that rate, the economy would be moving roughly in line with its long-run potential, calculated in terms of a steadily growing and more efficient workforce. That is probably the most viable pace for a sustainable prosperity in the 1980's.

According to the standard forecast, 1978 may witness some moderation of consumer spending for autos and other goods, following the speedup in that category earlier this year. Also, single-family home construction may retreat from its recent record pace, although mortgage-lending institutions still have ample funds to support a high level of activity. Inventory spending meanwhile should continue to reflect the underlying attitude of caution in the economy, as business firms adjust promptly to changes in their sales.

In contrast, several sectors of the national economy could grow at an accelerated pace in the year ahead. Despite its performance to date, business spending for new plant and equipment could be one such area, especially in view of the near-capacity levels of operation evident in many industries. Spending by state and local governments should grow, bolstered by Federal grants, by higher tax rates, and by the expanding economy's boost to tax revenues. (In fact, state-local governments this year have moved into a strong surplus position even while boosting their spending.) Again, defense spending seems more expansive in terms of the growth of military prime-contract awards, which are running roughly one-fifth above a year ago. On balance, then, we might expect continued growth but a change in the character of the expansion, with the fast-growing sectors of the past year slowing down and the former slow-growers speeding up.

Surfeit of Problems

Needless to say, a number of problems could arise to push the economy off the growth path that I have sketched. First, there is the massive and sudden shift toward deficit in the nation's trade with the rest of the world. After posting a large surplus in

1975, the U.S. recorded a $9-billion trade deficit in 1976 and perhaps a $30-billion deficit this year. The principal factor involved (although not the only one) has been the continuing upsurge in oil imports, which have jumped from $5 billion to $45 billion within the past half-decade.

Looking ahead, most observers see little chance of a reduction in the merchandise-trade deficit in 1978. Domestic petroleum supplies will increase because of the opening of the Alaska pipeline, but oil imports should still continue high because of purchases for the strategic petroleum reserve. U.S. farm exports may remain weak because of good harvests abroad and large carryovers in the world grain market. Meanwhile, the trade balance in industrial products may remain unfavorable, because of the continued pattern of sluggish growth in overseas economies. With all this in prospect, the worries over the nation's international position might continue, although some factors—such as increased foreign investment in this country—have helped offset the trade deficits to date.

Energy of course has been closely involved in both our domestic and international problems. The long-term trend toward lower energy costs has been at least temporarily reversed in the 1970's, and this historical shift has drastically altered production relationships in the world economy, creating the possibility of a prolonged period of reduced economic growth. (Incidentally, we tend to understate the problem by continuing to refer to the OPEC's four-fold boost in oil prices at the time of the embargo, because prices in 1978 may be roughly ten times higher than they were at the beginning of the decade.) The difficulty has been aggravated by our tendency as a nation to search for a political rather than

an economic solution to the problem—that is, by our failure to utilize the price mechanism for reducing energy demand and allocating scarce supplies. I rather doubt that the basic problem will be solved by the Senate's voting of tax credits to homeowners who heat with wood or to motorists who buy electric tricycles.

Some key industries have their own individual problems—agriculture for instance. It would be foolish to expect a continuation of the tremendous farm boom of four years ago. Still, after adjustment for inflation, the average farmer's net income is no higher now than it was a decade ago—and it's less than half the level reached at the peak of the export boom in 1973. (In contrast, per capita income in the larger national economy, in real terms, has risen about 30 percent over the past decade.) Part of the problem stems from the slower growth of farm marketings, partly reflecting such world market developments as the slowdown in demand from our overseas customers and the increase in sales by our overseas competitors. But basically, the farm sector remains beset by the inflation-bloated costs of land, labor, fertilizer and farm equipment, which in the aggregate have doubled since the beginning of the decade.

Then there is the steel industry. U.S. steel consumption has risen only 15 percent over the past decade, because of intermittent recessions, the loss of markets to substitute materials, and the recent slack in demand for capital goods. But to add to the domestic industry's problems, foreign imports have siphoned off the lion's share of this modest market growth, accounting recently for as much as 20 percent of the U.S. market. Meanwhile, domestic production this year has been running at an annual rate of

around 125 million tons—about the same as in 1964. Whether the cause is dumping or the simple lack of competitiveness, the domestic industry is in difficult straits. A somewhat similar case is the copper industry, which has to deal both with weak world-wide markets and with an all-out production drive by nationalized foreign producers.

Problems of Labor and Capital

Now, many people believe that the most serious national problem can be found in the continuing high level of unemployment. Unfortunately, that problem too often is badly measured and badly analyzed. Let's consider the data involved. The prolonged expansion has generated 6½ million new jobs since the beginning of the recovery—the most impressive increase of the past generation. In addition, during this expansion the jobless rate has dropped from 9 to 7 percent of the labor force—and despite its sideways movement since last spring, there are good grounds for expecting further improvement.

But this raises the question of where the rate should actually be at full employment. The statistics are inflated—in good times as well as bad—by women workers who move in and out of the labor force seeking temporary jobs, by teenagers who are priced out of the job market by high minimum-wage laws, and by some individuals who might not otherwise look for work but who are forced to register in order to qualify for certain welfare programs. There is indeed a serious unemployment problem in certain areas. Thirty-eight percent of black teenagers are reported without work, and a hard core of the labor force—almost one percent of the total—has been without jobs for six months or more. But those individuals will get jobs only if we develop better

training programs and create more low-wage entry-level jobs—not if we insist on adopting broad programs which stimulate the entire economy, and not if we continue to raise the barrier for young workers by constant legislative increases in the minimum wage.

We could also use more thorough analysis of the trade-off problem. I for one would argue that the very notion of a trade-off between unemployment and inflation is fundamentally misleading. Recent evidence suggests that under some circumstances, inflation tends to *increase* rather than to *decrease* joblessness. A study prepared at my bank by Joseph Bisignano, which appeared in the summer issue of our *Economic Review,* provides such evidence for the U.S., and similar results have been noted in such countries as Great Britain, Canada and Italy. This perverse impact of rising prices on unemployment can be explained by the reactions of both consumers and producers, who associate inflation with increased uncertainty about the future. Households, more uncertain about the future value of their real incomes, tend to cut back on their spending plans. Businesses, more uncertain about the rate of return on new capital, tend to reduce investment in plant and equipment. The actions of both groups lower the total level of demand in the economy, and thereby tend to raise the unemployment rate.

Perhaps the most telling indicator of our economic malaise is the sluggishness of job-creating investment, and beyond that, the weakness of corporate profits. This seems to be the gist of the depressing message that Wall Street has been sending us throughout all of this year. (Incidentally, Wall Streeters claim that there's only one difference between the stock market and the Titanic—

there was a band playing aboard the Titanic.) One important factor is a weakness of business confidence, which leads people on both Main Street and Wall Street to demand increasingly high risk premiums. As evidence, we see a shortfall of spending on new plant and equipment, especially long-lived investments whose profit expectations are concentrated a decade or two in the future. Spending on short-lived assets—those with rapid rates of cash return, such as trucks and business equipment—has advanced in real terms at an 8-percent annual rate over the course of this business expansion. On the other hand, spending on long-lived assets such as major construction projects has increased at less than a 3-percent rate over this same time-span. Underlying this growing investment risk is a profound uncertainty about the shape of the future economic environment in which new facilities will be brought on line.

The weakness of business confidence reflects to some extent the uncertainties created by pending legislative cost increases—energy, social security, tax reform, minimum wage, hospital and welfare reform—not to mention the costs of past environmental and health legislation. But even more basic is a weakness of business profits—a problem which is aggravated by the public's misunderstanding about the actual level of profits. The commonly cited profits figures—the book profits that businesses report to their stockholders—have risen sharply in the last few years, to about double their level of a decade ago. But as you well know, raw profit figures have become almost meaningless as a guide to corporate health because of the way in which inflation distorts cost calculations.

Under historical cost accounting, the true costs of producing goods are badly under-

stated with respect to both the drawdown of materials from inventory and the consumption of capital assets—and consequently, profits have become seriously overstated. When we make the proper adjustments, we find that the level of corporate profits was overstated in 1976 by about $30 billion, resulting in an overpayment of close to $12 billion in income taxes. And when we use a replacement-cost basis for the tangible-assets portion of equity capital, we find that the after-tax return on stockholders' equity has averaged only about 3¼ percent throughout the 1970's—about two percentage points below the average rate of return for the 1950's and 1960's. These statistics are ominous for job-creating investment activity, especially in view of the historically close correlation between the rate of return on stockholders' equity and the rate of real investment.

Inflation and Deficit Spending

Obviously, then, the expected strength of the 1978 economy could yet be undermined, for a number of different reasons. As I've indicated, the problem list includes the record deficit in our international transactions, the upsurge in energy costs, the cost squeeze in agriculture and other basic industries, the continued high level of unemployment, the severe stock-market decline, and the related weakness in business profits and in business investment plans. But throughout all our problems runs a single common thread—inflation, which continually undermines the health of our economy. Admittedly, inflation has increased at "only" a 4-percent rate over the past several months, reflecting some easing in food and other commodity prices. But most analysts agree that a 6-to-7 percent rate of inflation has become imbedded in the overall economy, judging either from the past year's trend of prices, or the in-

creases in wage costs incurred by major pattern-setting industries, or the amount of past fiscal and monetary stimulus.

The search for the basic cause of these price pressures always comes back to the long series of Federal budget deficits incurred over the past decade or so. Deficit spending has worked to pull monetary policy off target in an expansionary direction, by supporting excessive growth of money and credit. This happens because the rise in total credit demands, swelled by large-scale Federal borrowing, tends to raise interest rates. Higher rates then undermine the strength of certain vulnerable sections of the economy, such as small business, agriculture, housing, and state and local governments. In an effort to minimize this type of impact, the Federal Reserve has often delayed taking firm action to head off excessive growth in money and credit.

Total Federal spending has grown at an unparalleled pace in the late 1960's and early 1970's. Defense spending has contributed to this budget growth, notably during the Vietnam War period. But the most worrisome increases, which are not even reviewed by Congress after the initial legislation, have been recorded in what budget makers call "uncontrollable" categories—certainly a very apt description. Most of these programs involve the automatic transfer of money to anyone eligible under entitlement formulas written into law. Ballooning expenditures have been the result. Federal spending first exceeded $100 billion in 1962, but by fiscal 1977 it exceeded $400 billion a year. And with the slower growth of revenues, deficits have continually mounted, so that the cumulative deficit over that decade and a half amounted to a massive $337 billion. By failing to increase direct taxes to cover this increased spending, the Federal government decided in

effect to impose a silent yet severe tax—inflation.

There are hopeful signs in the reform achieved under the Congressional Budget Act of 1974, which provided a mechanism for determining Congressional priorities and relating expenditures to prospective revenues. There are hopeful signs too in some aspects of the recent budget picture. The deficit for fiscal 1977 amounted to $45 billion—$23 billion below what the Administration had expected early in the year. This came about partly because of the healthy increase in revenues, and partly because of the unexplained failure of bureaucrats to do what they usually do best—that is, spend money. From these indications, it's possible that the fiscal 1978 budget will also be lower than expected. Still, that's little consolation when we consider that the projected $58-billion deficit figure approaches the worst recession figure, because an expanding economy such as ours should not require that much stimulus from deficit financing.

Financial Markets and Interest Rates

Now, the offsetting nature of the various factors that I've discussed—the moderate strength of the business expansion, along with the effects of inflation and related problems—might suggest a virtual standoff in financial markets in the year ahead. Credit extensions have sharply outrun GNP growth this year; in the third quarter, for example, total borrowings ran roughly 30 percent above a year ago, at about a $400-billion annual rate. If the pace of the economy should moderate, that type of financial pressure should moderate as well. For example, we might experience some sluggishness in consumer-credit and mortgage demands, offset by an increased corporate reliance on external financing. Yet even after several years of expansion, our financial markets still appear to be structurally

very sound. Business corporations have increased their ability to withstand external strains, by building up their liquid assets and establishing standby borrowing facilities for use in meeting future operating needs. Similarly, financial institutions have increased their ability to withstand such strains, by stretching out the maturity of their liabilities and increasing their holdings of short-dated governments. But here again, the size of the Treasury deficit appears crucial. A hold-down on deficit spending is necessary if we are to limit Treasury borrowing demands on the market and stave off the threat of "crowding out" for another year.

This brings up the question of interest rates—a topic of keen importance in recent months. Last summer, in a talk here at Town Hall, I quoted Irving Fisher on that subject, and I think it wise to quote him again, especially since some prominent economists appear to have overlooked Fisher in their graduate-school reading. Several generations ago, Fisher said, "Probably the great majority of businessmen believe that interest is low when money is plentiful, and high when money is scarce. This view however is fallacious, and the fallacy consists in forgetting that plentiful money ultimately raises the demand for loans just as much as it raises the supply, and therefore has just as much tendency to raise the interest rate as to lower it."

What Fisher tells us is that we should distinguish between two kinds of rates—the real rate and the nominal rate which is quoted in the market-place. The real rate is measured in terms of *real* purchasing power over goods and services, and the nominal rate is measured in terms of *nominal* purchasing power. If lenders and borrowers all believed that the purchasing power of money would remain constant, the two interest

rates would be the same. But in recent years, they haven't been able to make that supposition. In this inflationary atmosphere, money rates have risen considerably above the real rate. With prices expected to rise at (say) 5 percent a year, lenders have demanded the real rate plus 5 percent, so that they would be protected against an expected loss in the purchasing power of money. Borrowers meanwhile have been willing to pay this 5-percent (or whatever) inflation premium, because they expect to repay their loans with dollars that are worth 5 percent less each year than the dollars they originally borrowed.

Now, most people understand the role of business fluctuations in pushing rates up and down. In recent decades, interest-rate peaks have roughly coincided with business-cycle peaks, and interest-rate lows have usually followed recession lows after a few months' time. Most people also understand (at least dimly) the short-term ability of the Federal Reserve to push rates down through easier money conditions or to push rates up through tighter policy. Yet too few people clearly understand the long-term effects of price expectations on interest rates, and the way in which such expectations can offset other market influences. Our recent experience should teach them that monetary restraint can drive up the real rate by reducing the supply of funds—but that it can also drive down the inflation premium by reducing inflation expectations. Short-term interest rates have risen almost two percentage points since last spring, but long-term rates—such as the yield on new issues of prime-quality utilities—have remained virtually flat over this period.

Monetary Policy Problems

As you know, Fed policy has been attacked recently from two opposite directions,

which may be evidence in itself that we're on the right track. Those critics who closely follow money-supply trends argue that policy has been too easy, and that it will inexorably lead to severe inflation. Those critics who closely follow every basis-point rise in interest rates claim that policy has been too tight, and that it will condemn us to a credit crunch and a renewed recession. Our duty, however, is to thread a middle course between those two extremes, recognizing our responsibility for supporting the sometimes conflicting goals of economic growth, high employment, price stability and stable financial markets.

In today's economic and financial context, the best policy prescription is to pursue a gradual reduction in the growth rates of the monetary aggregates, to a level consistent with long-run price stability. This is the course on which the Fed set out in March 1975, when it began the practice of making quarterly reports to Congress regarding our targets for monetary growth over the year ahead. Earlier this year, for example, Chairman Burns announced a lower M_1 target growth range for the year ahead, of 4 to 6½ percent, and in his latest testimony two weeks ago, he announced a lower M_2 target range, of 6½ to 9 percent.

Money growth actually has been above the target ranges over the past year, averaging about 7 percent for M_1 and 11 percent for M_2. Yet some critics claim that even faster growth is needed to support a strong economy, because the growth of the real money supply has been modest in the context of a 6-percent inflation rate. Their prescription, then, is to increase the rate of money growth to step up the growth of the underlying economy. I would have thought that that type of analysis went out of style with the German inflation of the 1920's, when people ran around with baskets of money trying to buy loaves of bread. More rapid

growth now would guarantee even more inflation in the future, which according to the argument I cited, would call for a further increase in the rate of money growth. But at some point, it would be necessary to slam on the brakes, with disastrous consequences for the economy.

I believe that, if we are to be effective in carrying out our monetary-policy responsibilities, continued Federal Reserve independence is essential now more than ever. The founders of the Federal Reserve early in this century introduced a measure of discipline into policymaking by ensuring the independence of the central bank within the structure of the Federal government. For example, the law provides that the Fed's Board of Governors shall have seven members appointed to staggered 14-year terms to prevent packing the Board. The law also gives the Fed an independent source of revenue, the interest earnings on its portfolio of government securities, to prevent it from being coerced by Congressional control of its purse-strings.

Within that structure, we in the Fed have been able to make prompt and (if need be) frequent changes in monetary policy, in contrast to the necessarily ponderous processes of fiscal policy. We have also been able to make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. Certainly, the Fed has stumbled on some occasions, but it's hard to imagine our problems would have been solved if the control of the monetary authority had been turned over to the Executive branch or to Congress. Indeed, if the spending propensities of Federal officials had been given freer rein through easier access to the "printing press," our inflation problem of the past decade probably would have been far worse than it actually was.

Concluding Remarks

After analyzing my remarks—especially my long list of problem areas—you'll probably ask how we could possibly expect to achieve business and financial strength in the year ahead. My first answer is that I expect a continuation of the generally correct line of policy initiated several years ago. Despite all the disaster scenarios written at the bottom of the recession, within 2½ years we have achieved an increase of 15 percent in real output, an addition of 6½ million people to the employment rolls, a drop of 2 percentage points in the jobless rate, a reduction by half in the inflation rate, and a rise of 10 percent in real per capita income. Obviously, private and public decision-makers must have done something right during this period. Even some of the policy mistakes of recent years can be explained in terms of the nation's constant effort to serve as the prime "locomotive" of the world economy.

My second reason for optimism is based on our nation's long-run record of achievement. Sometime in the next several months we will pass a major landmark—a $2-trillion GNP. At that point, we should pause to remind ourselves of the remarkable record achieved just since 1929, a year which we normally consider the peak of a golden age. Within this half-century, we have recorded more than three-fourths of the entire increase in real output achieved since the founding of the Republic. And how was this done? Simply through a modest yet persistent long-term increase of 1.7 percent per year in real per capita output. The case for a moderate-growth policy can be summed up in that single statistic, so if we continue to observe that lesson from the past, we will have within our grasp a record of steady growth, high employment, and stable prices in the decades ahead.

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