ECONOMIC OUTLOOK FOR 1971

Speech Presented by Darryl R. Francis,
President, Federal Reserve Bank of St. Louis
at National Mortgage Banking Conference
Chase-Park Plaza Hotel
February 12, 1971

I am pleased to have the opportunity to discuss with you the economic outlook for 1971. The implications of national economic trends for your industry are too obvious for me to belabor here. Consequently, I feel that I can be most useful to you by discussing trends in the national economy as we see them evolving at the Federal Reserve Bank of St. Louis.

I would like to discuss three topics with you. First, I will review the developments of the 1960's which led to our current inflation. Second, I will summarize the present situation, and, third, will give our outlook for 1971.

Review of the 1960's

In reviewing the developments of the 1960's which produced our current problem of curbing inflation, I refer you to several charts. The first chart (Figure 1) is "Demand and
Production." The top line, labeled "Total Spending," defined as gross national product in current dollars, is the total spending of households, business firms, and governments (state, local, and Federal) on goods and services -- the total dollar volume spent on final goods and services. Total spending moves upward for two reasons: (1) a larger quantity is purchased, or (2) higher prices.

The second line, labeled "Real Product," is real gross national product. It is quantity produced, or physical volume. This measure of real output increases for the reason that more and more units are produced.

A problem in economics is that unit sales of real product can increase only so much a year when we are at full-production employment of our resources, particularly labor force and plant capacity. Given such conditions, output can grow over time only as our resources grow and our technology progresses. So we are limited at full employment to a growth rate of about 4 per cent each year for real output. In some years real product growth,
however, may depart from 4 per cent, for example when we come out of a recession, as in the early 1960's.

Look now at the gap between the two lines. The gap represents price increases; that is, were it not for changes in prices, total spending and real product would be identical. When these two lines diverge, this represents inflation, and when the gap widens it represents an acceleration of inflation. As an approximate guide to the rate of inflation on this chart, subtract the rate of increase of real product from the rate of increase of total spending. Chart 2 presents movements in the general price level.

With the aid of these two charts, let us now examine the course of our economy from the early 1960's to the present. Look now at the early years of the 1960's. We had an expansion from the first quarter of 1962 to the fourth quarter of 1964, with total spending growing at a 6.1 per cent annual rate and real product at a 4.6 per cent rate. This was a period when the unemployment rate persisted near the 6 per cent range. Subtracting 4.6 from
6.1, we find that prices rose at about a 1.5 per cent annual rate. Economists do not label that as inflation because we know there is great imprecision in our measurement of price increases. So a 1.5 per cent rate of price rise is considered sort of a normal situation, particularly when you take into consideration quality changes for the goods which make up our gross national product.

Then, in 1964 we began to have an acceleration of total spending which rose from the fourth quarter of 1964 to the fourth quarter of 1966 at a 9.3 per cent annual rate. This was the period of the acceleration of the Vietnam War and an acceleration of non-defense expenditures. Many analysts have lost sight of the fact that nondefense expenditures accelerated just as rapidly in this period as defense expenditures. This was thus a period in which we had a very rapid increase in total Federal government spending.

While total spending rose at a 9.3 per cent rate, real product rose in the early part of this period to an 8.2 per cent annual rate because we still had considerable slack in our economy. This period the unemployment rate moved down to 4 per cent. This
was a period in which plant capacity utilization increased into the mid-90 per cent level. In about the fourth quarter of 1965 our economy peaked out; and we hit our full employment rate of growth. We could not expand output any faster because we did not have idle resources which could be pulled into use.

Real output grew at a 4.9 per cent annual rate, and that is the point where the gap between total spending and real output growth widened; this is where we began to have an acceleration of inflation. There was a slight economic pause in late 1966 and early 1967. Then, from the second quarter of 1967 to the second quarter of 1968, total spending again rose at a 9 per cent annual rate and real product at a 5 per cent rate, resulting in a 4 per cent rate of inflation. Then, for the period from mid-1968 to mid-1969, total spending growth slowed to a 7.8 per cent rate. As a result, some economic slack developed, but inflation jumped to about a 5 per cent rate.

Let us now examine the contributions of monetary and fiscal actions to the economic developments I have just outlined.
The chart labeled "Money Stock" (Figure 3) shows the contribution of monetary policy to our present economic situation. At the Federal Reserve Bank of St. Louis we use the rate of change of the nation's money stock to indicate the influence of Federal Reserve action on economic activity. By Federal Reserve action I mean changes in the discount rate, in reserve requirements, but more importantly, changes in our open market purchases of government securities. Whenever the rate of increase of money accelerates, it is an expansionary monetary action. When it goes from a high rate to a lower rate of growth, this is a restrictive monetary action.

Consider now the course of the money stock from 1962 to the present. We find that from late 1962 to mid-1965 the money stock rose at a 3.9 per cent rate. This period was one of sustained expansion without rising inflation. The money stock from May 1965 to April 1966 rose at a 6.3 per cent rate. That represented a marked acceleration, and at that time it was the fastest rate of growth in the nation's money stock since the inflationary days of
the Korean War. Then, as you remember well, came the credit crunch of 1966, when the money stock did not rise at all for about 8 or 9 months.

Starting with January 1967 and carrying through to January 1969, the nation's money stock rose at a 7.6 per cent annual rate. This was the fastest rate of growth in money since the inflationary days of World War II. Since early 1969, monetary policy has been characterized by a slowdown in the first half of 1969 to a 5.1 per cent rate of growth in money, virtually no change in the last half of 1969, and slightly over a 5 per cent rate of growth in 1970.

The chart of Federal Budget Influence (Figure 4) shows the high-employment budget surplus or deficit. The present administration is using this budget concept for planning economic stabilization policy, but in the 1960's it was used as an indicator of fiscal influence. This concept shows what the budget surplus or deficit would be if we had full employment. It moves primarily
when we have a change in the taxing provisions of the Federal
government or changes in the rate of increase of government
expenditures. When this line moves up, it indicates restraint;
and when the line moves down, it indicates a stimulus emanating
from the Federal budget.

For 1962 and 1963 we had a budget surplus by this measure
of about $10 to $15 billion. That sharp break in 1964 reflected
the tax cuts of 1964 which carried on into 1965. Then you see the
steady movement downward to the greater and greater stimulus of
mid-1965 to mid-1968. This represents, first, the acceleration of
the Vietnam War expenditures, and, second, the acceleration of non-
defense expenditures. By mid-1968, this measure was in deficit by
$15 billion.

By mid-1969, this measure of fiscal actions indicated
fiscal restraint. It had moved sharply upward to a surplus of $10
billion as a result of the income surtax plus the Expenditure Control
Act of mid-1968. The movement was downward again in 1970, reflecting
the phasing-out of the surtax and rising nondefense expenditures.
From this review of monetary and fiscal actions we can conclude that during the period of the 1960's when we had acceleration of inflation, there were two important forces at work. First, fiscal policy was stimulative, and, second, monetary actions were also stimulative. This course of policy on the part of our national government, according to my view, was the main cause for our present inflation.

The Present Situation

Now I would like to review briefly the present situation as a jumping-off point for analyzing 1971. There are several observations I would make regarding the present situation.

First, a very important point: we have only had restraint for about two and one-half years. We had restraint starting with the fiscal actions of mid-1968 and the monetary actions in 1969. Even though we have had restraint for about two and one-half years, very little progress has been made in the fight against inflation.

In 1969 inflation actually accelerated to about a 5.5 per cent annual rate on a GNP deflator basis. And, in 1970, the rate of
inflation slowed down very little, maybe 1 percentage point. So I might say that we have made very little progress at the present time in the fight against inflation. Also, we have had rising unemployment, particularly in 1970, when we reached an unemployment rate of 6.2 per cent in December.

Why was this situation allowed to develop? I think the first reason, which really became obvious about a year ago, is that inflation carries on under its own power, under what I call an inflationary momentum. When we exercised restraint in late 1968 and early 1969, inflation had been growing for about four years. This high and accelerating inflation was the jumping-off point for exercising restraint. With the inflationary momentum that had developed, the initial impact of restraint was on employment and output rather than on prices.

Another reason for the very slow fight we have had against inflation is that very mild restraint has been applied thus far. We have not exercised great restraint on total spending in the economy. The surtax was only temporary, and we have
had very mild monetary restraint. We have not reduced the nation's money stock; we only leveled it out for about six months and then have had a fairly rapid growth in money.

Finally, the adjustment so far in terms of output has been very mild compared with other episodes of the 1950's. This has been a saucer recession, a plateau essentially, with a very mild decrease in real output in the last part of 1969 and early 1970. Since then it has remained flat. We have not had a wide swing in real output. Also, unemployment has crept up more slowly in this recession than in the previous recessions following World War II.

Outlook For 1971

With this background let us examine the outlook for 1971. I might state that this outlook has to be very limited because I am an official in the Federal Reserve System. I cannot give you a very exact outlook, because that would hinge on my view of what Federal Reserve policy will be. I certainly could not disclose that, even if I knew what policy was going to be for the balance of this year.
What I have done is to develop the outlook for 1971 in terms of two hypothetical rates of growth of the money stock. One is a 5 per cent rate of growth of money from the fourth quarter of 1970 to the fourth quarter of 1971. This is about the rate of increase we had in 1970. It represents a continuation of the recent trend.

The second assumed path of monetary actions is an 8 per cent rate of growth of money which would be a substantial relaxation of monetary policy and would provide added stimulus to the economy. Of course, there are many persons who advocate this sort of a stabilization policy. For government expenditures we are taking the recent budget measures as a basis of inferring an amount for each of the four quarters of 1971.

We estimate that nominal GNP (total spending) will rise at about a 6 per cent rate throughout each of the quarters of 1971 if we have a 5 per cent rate of growth of money. But what is more important are the implications of this alternative for growth in real product. This rate of monetary expansion will produce slow
growth in the first half of the year of about 1.6 or 1.7 per cent annual rate. Then for the last half of the year output growth will average about a 3.5 per cent annual rate of increase. This would be very moderate expansion, with some growth in the first half of the year and a moderate pick-up in the last half. I might add that these estimates do not allow for the distorting factors relating to catch-up production after the auto strike or stockpiling of steel in anticipation of a strike.

What are the prospects for prices? I am a little less than optimistic with regard to our fight against inflation. It has been our view for the past two years that it would take from three to five years to curb inflation. We have had two years of this process already, so in another couple of years we could see the end of significant inflation if money continues to grow only moderately. Assuming a 5 per cent growth rate in money, we estimate that the rate of increase of prices, as measured by the GNP deflator, will gradually decrease during 1971 from about the present 5 per cent to a little under a 4 per cent rate a year from now.
We estimate that unemployment will be a little above 6 per cent by the end of 1971. We already had a 6.2 per cent rate in December, but the General Motors strike tended to distort that figure. In other words, unemployment as a per cent of the civilian labor force has probably peaked, but will remain at a high level in 1971.

Turning to the other alternative, an 8 per cent rate of increase in money, we believe there would be a moderate increase in real output, in the first quarter at a 2.2 per cent rate, up to a 3.4 per cent rate, and then averaging about a 6 per cent rate over the last half of the year. This would represent a fairly substantial recovery from our present recession. As a result of having real output grow at a rate faster than potential at the end of the year, we would find the unemployment rate peaking at 5.8 per cent and then working down to 5.6 in the fourth quarter of 1971. We still would have an average 5.7 per cent unemployment rate and a 4.5 rate of inflation for the year.
Summary

Now I would like to summarize briefly my remarks. I think my 1971 outlook is for a very slow recovery in real output during the first half of the year and only a moderate pick-up in the second half. The extent of these movements will depend in considerable measure on Federal Reserve policy. Under present policy we would have only a moderate pick-up but there would be a more substantial pick-up if we had a more rapid rate of increase in the money stock. We could have the unemployment rate decreasing by the end of 1971 if we had a more rapid growth of money, but this policy should take into consideration some implications for the years after 1971. Faster money growth runs a great risk of rekindling inflationary pressures. In that case, while we would make gains against unemployment, we would find ourselves in a position of having to fight inflation at a later date in 1972, 1973, or 1974. And, at that time, it would become more difficult yet to curb inflation. It would take greater effort, greater restraint, and, in my opinion, much greater loss of output and a greater rise in unemployment than we have had up to now.
Demand and Production


Latest data plotted: 3rd quarter

Prepared by Federal Reserve Bank of St. Louis

[Notes]
1. GNP in current dollars.
2. GNP in 1958 dollars.

Percentages are annual rates of change for periods indicated.
General Price Index

Percentages are annual rates of change for periods indicated.

Latest data plotted: 4th quarter preliminary

Source: U.S. Department of Commerce

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Money Stock

Percentages are annual rates of change for periods indicated.
Revised series - November 1970.
Latest data plotted: December

Prepared by Federal Reserve Bank of St. Louis
Federal Budget Influence
Stimulus or Restraint
Quarterly Totals at Annual Rates
Seasonally Adjusted

Latest data plotted: 3rd quarter

*The High-Employment Budget, first published by the Council of Economic Advisers.