THE ECONOMY IN 1972

Speech by

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It is good to have this opportunity to discuss with you some of my views on the outlook for the United States economy in 1972. Economic projections are often of little significance to most people because our vast economy is normally very stable and important changes occur only slowly over time. The economy might be compared with a great ocean liner which changes course so smoothly that most passengers are unaware that a shift of direction has even occurred. For the most part, only the captain and the crew, who are involved in making and plotting the course corrections, pay much attention to the ship's movements.

From time to time, however, the ship is buffeted by strong winds and high waves. During these periods, the passengers develop a strong personal interest in the vigorous actions of the captain and crew to keep the ship on course.

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1972 will likely be a year in which economic developments are followed with such intense personal interest.

Unemployment is one of the ill winds which continue to blow. With the unemployment rate still high by historical standards, many people remain concerned about their ability either to obtain a job to their liking or retain their present one. Inflation and potential inflationary pressures also continue to disturb many Americans. Some issues in the highly complicated international monetary picture have been cleared up, but a number of troublesome, yet important points are unresolved.

To assess the most likely course of economic activity over the next several months, I will discuss first the current state of the economy, second, monetary and non-monetary influences on spending behavior, and finally, the outlook for 1972. Let us begin by examining the current state of economic activity.

1971 was a year of mild recovery from the mild recession of 1970. The recession of 1970 was preceded by moderately restrictive actions taken by the monetary and fiscal stabilization authorities to curb inflation, and the recovery year 1971 was preceded by moderately expansive

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actions taken to "get the economy moving again." Given the momentum of strong inflationary expectations and the usual lag with which policy actions work, it should not have been surprising that inflation was not stopped in its tracks by the slightly restrictive measures taken in 1969. Our Bank's model of the economy indicated in late 1969 that price rises could not be halted quickly without incurring a severe temporary rise in unemployment.

The unemployment rate, which began to rise in early 1970, was never as high in 1971 as in 1958 or 1961, years of the two most recent recessions. Let me digress for a moment to discuss the very important issue of unemployment. Unemployment is a waste of resources from the national point of view and a serious personal concern to the unemployed individual. A significant drop from the current high unemployment rate of about six per cent is rightly a goal desired by all policymakers. But let me point out that the nature of unemployment has changed a great deal over the years, and the methods by which it should be attacked must show similar flexibility.

In past periods of high unemployment, much of the burden was carried by heads of families, full-time workers whose loss of employment was a serious hardship for adults and their children as well. Today, a large number of unemployed are not married family men, but teenagers and women working to supplement the chief bread-winner's family

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income. Their unemployment is, of course, also a matter of private and national concern, but probably not so much as with family heads. Relatively high unemployment rates for women have occurred as more of them have joined the labor force to seek work, while the high unemployment rate for young people has resulted both because of their increasing desire to find employment, and because there are proportionately more of them than in past periods of economic slowdown.

The employment situation can best be placed in its proper perspective by focusing on growth of jobs rather than on the unemployment rate. The fact that 63.3 per cent of the population of working force age had jobs in 1971 compared to 61.8 per cent in 1961 and 61.4 per cent in 1958 reflects substantial underlying strength in the job market. The best ways to stimulate the creation of jobs for many often inexperienced workers such as teenagers, women and Viet Nam veterans are through specific "structural" measures such as job training, information and relocation subsidies and elimination of legal and institutional barriers to jobs, rather than aggregate stabilization techniques.

Rapid expansion of the money stock, for example, to stimulate aggregate demand and provide jobs for such workers would probably result in the re-emergence of

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inflationary pressures. On the other hand, the structural measures I just mentioned could put people to work without generating further inflation.

That the aggregate unemployment rate would remain high in 1971 was predicted reasonably well by most private forecasters, whether their forecasting was based on a view of the world which emphasized the importance of fiscal measures or one which stressed the significance of monetary actions. Many economists, however, did not foresee the continued advances in prices which led to the President's decision to impose wage-price controls, nor did they predict the sharp deterioration in the United States' balance of payments which precipitated sweeping international monetary reforms. There is considerable evidence that excessively stimulative monetary actions throughout much of the decade of the 1960's was the underlying cause of both inflation and our balance-of-payments difficulties. It is not difficult to understand why recent research has focused on changes in the rate of growth of the money stock as the chief indicator of future changes in important economic variables. Money, as generally defined, consists of demand deposits and currency held by the nonbank public.

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This recent research shows that increases in the rate of growth of money have preceded expansions in economic activity, and a slowing in the rate of growth of money has been followed by economic pause. There has been a distinct correlation between the length and degree of the rate of change of the money stock and the duration and scope of the corresponding economic expansion or contraction. In short, the more money is pumped into the economy, the more spending there will be, and the more money is drawn out of the system, the less spending there will be.

Whether the spending is channeled into real output changes or price changes depends on the degree of slack in the economy and the intensity of price anticipations. From 1960 to 1965, there was both considerable slack in the economy and expectations of stable prices; hence, most monetary growth was channeled into gains in real output and employment. In the 1965 to 1969 period, monetary growth accelerated, but since there was negligible economic slack, much of the change in total spending was reflected in price increases. In 1970 and 1971, there was substantial unemployment, but, because price anticipations remained relatively high, most of the gains in total spending were absorbed by price increases.

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Price increases leveled off in 1970 and 1971, but they had not yet clearly begun to decelerate when the President called for a wage-price freeze last August 15. Since the imposition of the freeze and the second phase of the President's program, measured prices have slowed. Problems of administration and equity will undoubtedly intensify the longer the program remains in effect, but for the moment at least, wage and price controls are having the desired effect. The potential for eventual success of the program is enhanced by (1) the fact that the controls have been accompanied by monetary restraint; (2) the fact that there is currently substantial economic slack; and (3) the possibility that controls may curb anticipations of higher prices.

Another significant aspect of the President's new policies announced August 15 are the measures taken to reverse the deteriorating U. S. balance of payments. Excessive monetary stimulus in the late 1960's combined with slackening comparative productivity in this country drove prices of many commodities produced by this country above the prices charged by our trading partners. It became inevitable that sooner or later the net export surplus on goods and services which we had enjoyed for many years would evaporate. Despite the President's efforts since

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August to encourage exports and discourage imports into this country, the United States' balance of payments on goods and services in 1971 was the worst since 1895. The imposition of the ten per cent surcharge on imported goods and the severance of the dollar from gold was designed to achieve three fundamental goals: (1) a more realistic re-alignment of major foreign currencies; (2) trade concessions from our trading neighbors; and (3) the initiation of talks designed to alter the character of the international monetary reserve system.

The recent devaluation of the dollar and removal of the ten per cent import surcharge set the stage for likely short-term benefits to the United States in terms of increased employment in export-oriented industries and potential long-term gains for all trading nations with the removal of restrictive trade barriers. I wish to emphasize that success in any international trade endeavor depends on many factors, but one of the most important influences on international economic activity over time is monetary conditions. Monetary actions affect not only the relative prices of goods and services among countries, but also influence the international flow of capital through changes in interest rates. In order, then, to assess the outlook for domestic and international

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economic developments in 1972, we must examine recent monetary growth rates, as well as the non-monetary factors which we can expect to influence such activity.

The performance of the money stock in 1971 was much more uneven than usual. After rising 5.4 per cent from December 1969 to December 1970, the money stock accelerated to a 10.3 per cent annual rate of growth the first seven months of 1971 and then slowed markedly to virtually no growth during the last five months of the year. These violent swings in money movements were accompanied by roughly similar changes in interest rates. The three-month Treasury bill rate, for example, rose from a low of 3.3 per cent in March to a peak of 5.4 per cent in July, and then fell to about 4 per cent in December. Since rapid monetary growth is often associated by many analysts with low rates of interest and slow monetary growth with high rates of interest, these money-interest rate patterns may at first appear unorthodox. Some would say the high rates of interest in the first half of the year represent "tight" money policies and the lower rates more recently depict "easy" money policies. Such conclusions are indicative of a frequent confusion between money and credit.

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Often an increase in the supply of money means a short-term increase in the supply of credit and a fall in interest rates. The drop in interest rates may be short-lived, however, because the increased money supply leads to expanded economic activity, and an even greater demand for credit to finance enlarged operations and offset possible future price increases. The increased demand for credit relative to the supply pushes up interest rates -- a scenario which emerged in the latter half of the 1960's.

At times, the effects of the increased supply of money on interest rates are outweighed by the demand for credit without a lag, so that the interest rate even in the short term moves in response to changes in the demand for credit rather than the effect of monetary expansion on the supply of credit. Something like this probably occurred in 1971. For the first half of the year real economic activity and price anticipations constituted sufficiently strong demand for credit to offset the rapidly expanding money supply, and thereby foster rising interest rates. By the third quarter of the year real activity had become somewhat sluggish and price anticipations had been partially broken by the wage-price freeze. Meanwhile,

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foreign governments were purchasing Treasury securities in large quantities to shore up exchange rates. Consequently, interest rates declined despite the slowing in the rate of growth of the money stock.

Falling interest rates in the latter half of 1971 have been viewed by many analysts as a spur to economic activity in 1972, and indeed a lower cost of capital is often one of the ways by which monetary changes influence spending. However, because there are channels other than interest rates through which monetary growth affects economic activity, the recent slower growth in the money stock will tend to have a restrictive effect on spending. An absorption of money from the economic system makes the possession of money more valuable to the holder just as a reduction in the stock of diamonds or works of art increases the value of the remaining stock. That is, monetary changes exercise a strong wealth effect on spending as well as a cost of capital effect. Thus, when the money stock expands rapidly, its value falls, and people exchange money for goods and services at a rapid rate. Conversely, when growth of the money stock slows, its higher value makes people more reluctant to exchange their cash for goods and services.

Monetary growth is probably the most important

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factor influencing my view of the course of spending in 1972, but it is certainly not the only one. We at the Federal Reserve Bank of St. Louis also believe fiscal actions are important. Fiscal, or budgetary, measures affect economic activity in two ways. First, Federal Government expenditures, whether financed by taxes or borrowing from the public, have an important short-run effect on total spending. Over time, such expenditures tend to displace private purchases of goods and services, but not in the short run. Second, increased Federal Government expenditures often induce expansion in the money stock, as the Federal Reserve "monetizes" the debt. The larger the deficit, the more likely is the Federal Reserve to increase its purchases of Treasury securities.

The Federal budget deficit in calendar year 1971 (on a national income accounts basis) was $21 billion, the largest deficit ever recorded. The net effect of the Administration's new fiscal proposals of last August and the ensuing actions by Congress have been to revise upward estimates of the budget deficit for 1972 from $20 billion to $24 billion. The high-employment budget, which assumes budget expenditures and taxes at a 4 per cent level of unemployment, is expected to shift from a $4.4 billion

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surplus in 1971 to a $0.8 billion deficit in 1972. Thus the budget, by such actions as the 7 per cent tax investment credit and the increased personal income tax exemptions, should have a stimulative effect on economic activity next year.

In fact, stimulative fiscal actions provide much of the basis for the very optimistic 1972 forecasts which you have probably been reading about in the newspapers lately. Virtually every economic analyst in print has predicted a record surge in spending next year. Such unanimity is difficult to understand in view of the additional uncertainties with which the analysts are faced in 1972. In general, the chief unknown influences on spending are monetary and fiscal actions, but this year the analysts must project also the expected impact of the possible removal of some trade barriers, the dollar devaluation, and foreign exchange rate adjustments, as well as the effects of price-wage controls, their duration, and the successive phases, if any, of controls. Uncertainty often breeds divergence, but this year the product of uncertainty is conformity!

Let us now turn to the specifics of this year's economic outlook. The standard projections of economic activity in 1972 include: (1) a $100 billion rise in total spending compared to a $75 billion increase in 1971;

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(2) a doubling of real product growth from 3 per cent in 1971 to 6 per cent; (3) a decline in the rate of price increases from about 4.7 per cent in 1971 to 3 per cent; and (4) a steady fall in the unemployment rate from 6 per cent to about 5.2 per cent by year end. Most forecasters believe these ebullient figures will be achieved by way of the following standard route: The consumer, bolstered by the progress of the wage-price control program and higher tax exemptions, starts spending more (and saving less); the increased expenditures reduce sellers' inventories, which must then be replenished; a greater sales volume leads to higher profits which, together with the tax investment credit, induce capital expenditures; exports accelerate in response to higher demand from abroad, thereby creating many more jobs; residential construction, state and local spending and Federal Government purchases of goods and services all pick up moderately.

What this line of analysis omits, whether its source is a large, two-hundred equation model of the economy or the back of an envelope, is a role for changes in the rate of growth of the money stock. The small econometric model of the Federal Reserve Bank of St. Louis which has been as accurate in its economic projections

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as any model I know, features, as its centerpiece, growth rates of the money stock. No one knows how rapidly money will rise in 1972, but if the growth is 6 per cent -- about the same increase as in 1971 -- the St. Louis model projects considerably smaller economic advances than the standard forecast. Real output, according to the St. Louis model, will increase 3 per cent, about as much as in 1971, prices will rise 4 per cent, somewhat less than in 1971, and unemployment will be little changed from this past year.

There are three basic reasons why this set of St. Louis projections differs so much from the standard: first, the model has incorporated the recent sharply lower growth of the money stock in late 1971; second, no provision is made for the actions of the price commission and pay board; and third, the model does not account for the expected increase in foreign demand for United States goods. Because price and wage controls likely will keep price advances in 1972 below what they otherwise would be, and because increased demand for exports will probably stimulate both output and employment, I would adjust the St. Louis projections for prices downward, and probably adjust output and employment upward. I would not, however, adjust these 1972 projections to the optimistics levels of the standard

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forecast since the standard is not itself "adjusted" for the recent slowdown in the rate of growth of money. If the slower growth of money continues much longer, you will probably note other analysts finding reasons to revise downward their rosy 1972 forecasts. In fact the Wall Street Journal reported that at the December meeting of the American Economic Association, there was already considerable speculation that the concensus forecast is too optimistic.

I am sure you have noticed by now that I have discussed only a limited set of figures for a few economic variables for a single year, 1972. To focus on such a narrow field is to miss much of the importance of current and future economic developments. Before ending this talk, I want to speak further of two such developments -- price and wage controls, and dollar devaluation. The adoption of price and wage controls by the United States Government in a period of peacetime is a move which has strong long-term implications for our basically free market economy. Although there have been some brief periods of success with controls in this country as well as in a number of foreign countries, instances in which inflation was effectively curbed over sustained periods are rare indeed. Price and wage freezes

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have typically been followed by controls inequitably applied and ineffectively administered.

The initial euphoria over the fact that someone is doing something to stop inflation has usually given way to dissatisfaction on the part of those whose incomes do not rise as fast as others and to cheating by those who cannot buy or sell goods at the administered prices. Once the controls are removed, past experience and present econometric models indicate prices may rise back to about where they would have been in the absence of controls. A large model of the economy to which our Bank has access suggests that prices would rise more rapidly in 1973 than 1972 if controls were removed toward the end of this year. This large model also indicates that without any controls, but with moderate monetary growth, there would be less inflation in 1973 than 1972. In any event, our free market economy would be best served with an early dismantling of the wage-price control program, despite the slight gains they contribute to the 1972 price projections.

Another important economic development whose full significance is not found in the 1972 projections is the emergence of a new international monetary system. The estimates of large-scale gains in output and employment

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due to the devaluation of the dollar relative to other currencies are probably much exaggerated, especially over a period as short as one year. Except for higher prices for some imported goods, the average American will not likely note any impact of the new exchange rates on his standard of living.

One of the most significant aspects of the events surrounding the devaluation is that the western world was presented a unique opportunity to avoid future payments crises by the adoption of an unpegged international monetary system. In the past, the dollar was pegged to gold at the price of $35 an ounce and other currencies were pegged to the dollar at varying rates. When the market price of gold rose above $35 an ounce, other countries demanded gold for their dollars, which they had accumulated through American purchases of lower-priced foreign goods. As inflation in the United States accelerated, continued purchases of foreign goods led to more dollars going abroad, greater balance-of-payments deficits and a dwindling U. S. gold stock. Foreign governments, on the other hand, often purchased dollars to maintain the artificial parity between their currency and an overvalued dollar.

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The suspension of the convertibility of the dollar into gold and the imposition of a 10 per cent import surcharge last summer was a violation of the spirit, if not the letter, of existing international monetary agreements. Such actions ran the risk of mass foreign retaliation in the form of destructive trade barriers. Apparently, a trade war will not occur this time, but one could develop in the future if inflation in the United States again accelerates, the dollar remains pegged to gold, and other exchange rates remain pegged too closely to the dollar.

Raising the price of gold relative to the dollar and widening the range in which other currencies are pegged to the dollar only treats the symptoms of the international problem, just as price and wage controls only treat the symptoms of inflation. Freely floating exchange rates and moderate monetary growth in this country would go a long way toward eliminating two of our most serious economic ills, not only in 1972, but for many years to come.

It is my conclusion that a constant and moderate growth rate of money, control over growth in government expenditures, and policies designed to reduce structural unemployment through improved information and education,

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will do more to maintain desired economic growth, than all of the artificial measures that are being proposed currently. Above all, the policymakers must understand that an economy of the size that we have in the United States cannot be steered in any direction instantaneously, and that effective policies must look to the long run effects, rather than to the short cures which often lead to long run instability.

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