

## CURRENT ECONOMIC OUTLOOK

Speech by

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It is good to have this opportunity to discuss with you my views on the economic outlook for the United States over the next few months. I will begin by examining the current state of the economy. Then I will discuss the outlook for the general economy and for agriculture. Finally, I will comment on some basic issues relative to the overall performance of our economy.

Let us begin by examining some factors which led to 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 monetary actions taken in 1969 to curb inflation. The recovery year, 1971, was preceded by moderately expansive 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. Research at our Bank indicates that sharp and sustained price rises cannot 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 the two most recent recessions of 1958 and 1961.

Most private forecasters predicted that the aggregate unemployment rate would remain high in 1971. Many economists, however, did not foresee the continued advances in prices which led to the President's decision to impose wage-price controls. Also few predicted 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 domestic inflation and our balance-of-payments difficulties. Recent research shows that increases in the rate of money growth have consistently preceded expansions in economic activity. Conversely, a slowing in the rate of money growth has been followed by a pause in economic activity. 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 faster money is pumped into the economy, the more spending there will be, and the slower money grows, the less spending there will be.

Whether spending is channeled into real output changes or price changes depends on the amount of slack in the economy and the expected trend in prices. From 1960 to 1965, there were both considerable slack in the economy and a prevailing expectation of relatively stable prices. Most monetary growth was thus channeled into gains in real output and employment. In the 1965 to 1969 period, monetary growth accelerated, but since there was little slack in the economy, much of the change in total spending was channeled into price increases. In 1970 and 1971, there was substantial unemployment, but inflationary anticipations persisted and most of the gains in total spending were absorbed by price increases.

The rate of price increase had leveled off in 1970 and 1971, but prices had not yet clearly begun to decelerate when the President called for the wage-price freeze last August. The imposition of the

freeze halted the inflation for three months, but Phase II has achieved little success to date in curbing inflationary pressures. Most prices have tended to rebound since the freeze was lifted. For example, the consumer price index has risen at a 3.5 percent rate since November, compared to a 4.2 percent rate in the six months prior to last August. The wholesale price index has increased at a 7.8 percent rate since November compared to a 4.8 percent rate in the six months prior to August. While the sharp increase in farm prices was an important factor in the wholesale price increases, the wholesale prices of industrial commodities have risen faster since November than in the six months prior to the August freeze.

The wage-price control program may give the appearance of some success. But we must remember there is currently some economic slack which is working to hold back inflation. I think we are finding out that inflationary expectations cannot be controlled by Government order. The only way that I know of to reduce such expectations is to reduce inflation and that means reducing the rate of growth of total spending.

In order to assess the outlook for economic developments in the near future, we must examine recent monetary growth rates, as well as nonmonetary factors which we can expect to influence economic activity. During the past year, the performance of the money stock has been 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 percent annual rate of growth the first seven months of 1971 and then slowed to virtually no growth during the last five months of the year. Money grew 6.2 percent during the year ending last December. Since December money growth has again picked up to a 10 percent rate.

In my view monetary growth will be the most important factor influencing 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 that fiscal actions are important. Fiscal, or budgetary, measures affect economic activity in two ways. First, increases in Federal Government expenditures, whether financed by taxes or borrowing from the public, have an important short-run effect on total spending. Over time, however, such expenditures tend to displace private purchases of goods and services. Second, increased Federal Government expenditures often induce

expansion in the money stock, as the Federal Reserve tends to "monetize" the debt in an effort to avoid large increases in interest rates. The larger the deficit, the more likely is the Federal Reserve to increase its purchases of Treasury securities.

The Federal deficit in the fiscal year ending June 1972 (on a unified accounts basis) was estimated to be \$38.8 billion. Although some now believe that the deficit will be less, it will still be higher than the \$23 billion deficit for fiscal 1971. A deficit of \$25.5 billion is officially forecast by the Administration for fiscal 1973. Thus the budget deficit, reflecting such actions as the 7 percent tax investment credit, the increased personal income tax exemptions, and a planned acceleration in the rate of Government spending, will work toward stimulating economic activity this 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.

Let us now turn to the specifics of this year's economic outlook. The standard projections of economic activity in 1972 include: (1) about a \$100 billion rise in total spending compared to a \$75 billion increase in 1971; (2) a doubling of real product

growth from 3 percent in 1971 to 6 percent; (3) a decline in the rate of inflation from 4.7 percent in 1971 to around 3 percent; and (4) a steady fall in the unemployment rate from 6 percent to about 5.2 percent by year end.

Are these optimistic figures attainable, and if so under what conditions are they likely to be met? In reply, I would contend that they are possible but are likely to be attained only if three important conditions are met.

First, there must be an improvement in the demand by foreigners for United States goods and services. Our balance-of-payments deficit of \$22 billion last year was the worst that the nation has experienced since World War II. <sup>1/</sup> The devaluation of the dollar and upward adjustment of foreign exchange rates should eventually help the U.S. to become more competitive in world markets. An improvement in the foreign sector would generate a positive influence on total spending, output, and employment. Gains in net exports to date, however, have not been realized. We had a deficit in net exports of \$6.0 billion in the first quarter of 1972 following deficits of \$2.2 and \$6.1 billion in the third and fourth quarters, respectively, of 1971.

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<sup>1/</sup> Net liquidity basis.

Second, wage and price controls must demonstrate more ability to curb inflationary pressures than has been evident to date. A lower rate of price increase not only represents the progressive achievement of the inflation target, but also permits any given amount of total spending to be channeled into output and employment gains. Unfortunately, the achievements of the price-wage control program have been, at best, disappointing. Consumer and wholesale prices have increased about as rapidly in the period since the freeze as in the months preceding the freeze. The same is true of most wages.

The implicit GNP price deflator, perhaps the best measure of prices throughout the economy, has likewise continued up. It rose at a 6.2 percent rate in the quarter ending in March. This increase plus the 1.7 percent rise in the fourth quarter of last year resulted in a 4 percent average increase for the two quarters, the same rate as in the three quarters prior to the freeze. The increase in prices since last August has been about what the econometric models indicated would have occurred without price-wage controls.

The third major condition required for fulfillment of the standard forecast is that money growth must be stimulative for the remainder of the year. A



6 percent rate of increase in the money stock (the average of the past four years) during the rest of 1972 would not be enough to generate a \$100 billion increase in total spending. If, however, the money stock continues to increase throughout 1972 at rates of 10 percent or higher, the standard forecast for GNP and output would likely be attained. On the other hand, past experience indicates that such a rapid rate of monetary acceleration, if it persisted for some time, could set the stage for even stronger inflationary pressures after 1972. Since I am a strong advocate of a significant reduction in the rate of inflation, this leads me to question the desirability of trying to rapidly achieve the output and employment targets set forth in the standard forecasts.

### Outlook for Agriculture

Another troublesome spot in the national outlook scene with respect to inflation is that of farm product and food prices. The outlook is quite optimistic this year from the farmer's view. Gross farm income may rise \$3 to \$3.5 billion from the 1971 level, and net farm income may increase \$1.5 to \$2 billion.

This improved outlook for agriculture reflects an increase in food demand with little or no increase in prospect for food output this year. The

physical volume of livestock marketings are not likely to change much from the 1971 level. Pork production will probably remain well below year earlier levels, and cattle marketings will be only moderately larger. Poultry production will continue up but probably slower than the average rate in most recent years. The gain in demand is thus reflected largely in rising farm prices in the short run. Crop prices are not expected to increase much from the 1971 average with the larger stocks in storage. Livestock prices, however, will average well above year earlier levels.

Let me hasten to add, however, that farm prices are just now catching up with the trend of the general price level. Prior to the recent increases, prices received by farmers had been relatively low for about two years as a result of the cyclical pattern of livestock production.

The catch up in farm prices occurred during a crucial period of the wage-price controls program. Since the end of the price freeze, rising food prices have been a major factor contributing to the increases in consumer prices. The increases have led to a sharp controversy relative to proposals for expanding the controls program to include farm products.

As pointed out recently by the Secretary of Agriculture, such controls will not work in our highly competitive farm sector. They would result in black markets, rationing, subsidies, and a whole host of Government officials checking prices, weighing packages, and hauling people into court.<sup>2/</sup>

### The Fundamental Problem

Agriculture is thus subject to inflation, the same fundamental problem that exists in the non-farm sector. Similar to the inflation in the nonfarm sector, its chief cause in agriculture is an excessive rate of money growth. As pointed out earlier, money growth has been excessive since 1965. We have slowed money growth for short periods since then, a few months in 1966, again in 1969, and during the last half of last year. But, when we reduce spending by a marked slowing of money growth we observe increases in unemployment. Firms and labor unions expect prices to continue to rise. Labor agreements are negotiated at excessively high levels quite independent of the changed demand conditions. Workers are laid off, and unemployment is the penalty which accompanies a rapid return to price stability.

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2 / Speech at the National Agricultural Outlook Conference.

A major objective of the wage-price controls was to reduce the expectations of higher prices and hold negotiated wages and prices to moderate levels until the inflation could be brought under control. Even with appropriate monetary actions, a period of another year or two may be required for the inflation to subside. In the meantime individual incomes are influenced by the arbitrary controls, and some groups contend that they are not obtaining their so-called fair share of national income. We have recently observed the withdrawal of most labor union representatives from the pay board for this age-old reason. Such pressure groups have been a major cause of the abandonment of direct controls in Western Europe.

In my view the impact of such groups on inflation is relatively small. I do, however, believe that all groups that exercise monopoly power are an impediment to competitive pricing and contribute to unemployment, inefficient resource allocation, and inequities in the allocation of income and product.

### Allocating Resources and National Income

In my view we should reduce monopoly power at all levels and provide for competitive pricing of resources and the free market allocation of income. We must accept either free markets or a less efficient

means of such allocations. Numerous alternatives to free markets are available. Some groups have organized and formed monopolies to enhance their share of national income. Others, including farmers, have called on the Government to assist in monopoly pricing practices. Still others have achieved some monopoly power through licensing and chartering restrictions. They often limit entry to occupations and reduce employment opportunities to new entrants to the labor market. A cursory examination of occupational groups reveals that a large proportion of the population is guilty of attempting in one form or another to enlarge its share of national income and product through monopoly practices.

Pure Marxists would solve the problem of income distribution by having all share equally in national income. Under their system, however, there is little incentive to produce. For example, if each of us were guaranteed a given share of national income we could probably find a more desirable way to spend our time than at our current jobs. A state which espouses equality of incomes or excessively reduces inequality resulting from free market forces must thus use dictatorial power to force people to work and produce efficiently.

A system of allocation on the basis of group or monopoly power is likewise inefficient. It causes unemployment during periods of monetary restraint. Output is reduced as resources move into less than optimum uses. International specialization of labor is limited as imports are restricted. Such a system of power allocation lends itself to major disparities in income. Furthermore, it leads to more direct Government control of the daily affairs of people and loss of individual freedom as confidence in markets deteriorate.

On the other hand, the market or free enterprise system allocates income and product according to one's contribution to output and does not require direct controls. For it to work, however, we must forego those special powers and privileges through which we attempt to get our so-called fair share of national income. The competitive market allocates income to each of us on the basis of individual production. It pays out a fair share to all producing agents including both capital and labor. If someone is not being paid a fair market price for his services, someone else will hire him since his output will produce a profit for some other employer. Neither labor, capital, or consumers can be exploited in a free competitive society. All get their fair share

based on their contribution to society in terms of goods and services. This system is more compatible with human dignity and freedom than any other system known.

It is understandable that any one occupational group would not want the market system to allocate its income when monopolistic means of allocation are used in so many other sectors. The Government price support and production control program is an attempt to provide the farmer with his so-called fair share. I suggest, however, that there is not enough real output for all to get what they think is their fair share; thus, we must allocate income and output either through the Government or monopolistic action or through the competitive market place. Since the latter method provides for both greater production of goods and services and greater freedom, in my view it is by far superior to any of the alternative choices. Thus, we should begin to dismantle these impediments to efficient markets in agriculture, business, labor, and other occupations. The only alternative is further erosion of freedom as we move toward more intensive direct controls.

### SUMMARY

In summation we have had several optimistic forecasts for 1972 relative to output, unemployment, and

the rate of inflation. But, if vigorous actions are taken to achieve the output and unemployment forecasts, we may have the economy poised for even stronger inflationary pressures after 1972. On the other hand, if actions are taken to reduce the rate of inflation gradually, output may approach capacity slower than predicted. The resulting expansion, however, would be sounder. It would lead to stable prices which are consistent with faster growth rates and more efficient allocation of resources.

One of the problems contributing to unemployment during actions taken to reduce inflationary pressure is the exercise of monopoly power by groups organized to gain a larger share of national income and product. Together these groups constitute a large portion of the nation's population. Individually they all work for the good of their members. Combined they are detrimental to national welfare and eventually they may lead to a further loss of freedom for all citizens.

The only alternative, as I view it, is a return to greater reliance on market forces to allocate resources and income. A move in this direction involves each group giving up its monopoly powers. Business and other occupational groups would have to forego some chartering and licensing features which limit competition. Labor unions



would have to be broken up into smaller units and perhaps become subject to anti-trust laws. Farmers would lose their Government price supports and production controls and all would lose their special benefits from tariffs and import quotas.

Almost all, however, would gain in the process of moving toward competitive prices. Total output of goods and services would be enhanced. Unemployment would decline, and many of the inequities in income distribution would disappear. In addition to these material benefits, the free market system is consistent with a minimum of government controls and maximum freedom, and dignity of the individual.