Remarks by
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It is good to have this opportunity to discuss with you our assessment of the economic outlook for 1975. In view of the seriousness of the current situation and changes being implemented in governmental programs, the outlook is subject to greater uncertainty than usual. Nevertheless, we at the St. Louis Federal Reserve Bank believe that the old rules of economics still hold, and that useful evaluations of the near-term future can be gleaned from studying recent fiscal and monetary actions and the momentum of economic developments. In short, we subscribe to the "old-time religion" as applied to economic stabilization and forecasting because the "newer religions" have not produced any concrete proposals and have not given us any reason to forsake the old.

Since the recent trends of economic developments are likely to have a significant influence on future activity, I will first assess the current state of the economy. In this examination, attention will be devoted to what we consider to be chief causal forces. This review of underlying forces is undertaken

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in order to make judgments on the strength and likely endurance of current trends and to have some basis for evaluating the effects of any changes in these forces. After this analysis, I will present our view of the most likely course next year for production, employment, and prices based on our judgment of the recent trends, their causes, and our assumptions on the most probable changes in national economic policies.

Economic Problems

As we all know, the economy is now in great disarray. From the first to fourth quarters of 1973 growth in real output of goods and services slowed to a 2 percent annual rate, and since the end of 1973 real output has declined at a 4 percent rate. By sharp contrast, output rose at an average 4 percent annual rate from 1964 to 1972.

Reflecting cutbacks in output, employment has declined in some areas. Nevertheless, total civilian employment has risen about three-quarters of a million net since April, or at a 1.7 percent annual rate. This is roughly the same as the long-run expansion of population of working force age. Yet, because of a higher portion of the population desiring to work, the unemployment rate also has risen recently, reaching 6 percent of the labor force. This is up from the 4.8 percent average level in 1973, and compares with the 5.8 percent average which existed in 1971 and 1972.

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In addition, the country is suffering the ravages of a severe inflation. Consumer prices have advanced at a 10 percent annual rate since the end of 1972. By comparison, during the Vietnam conflict (1965-72), these prices rose at an average 4 percent per year, and in the pre-war years (1959-65), prices rose at a 1.3 percent pace. The inflation, which many feel is our most serious economic problem, is causing great redistributions of wealth and income. To the extent that it has been unanticipated, those with claims expressed in constant amounts of dollars have lost purchasing power. Also, the inflation has had the effect of a heavy tax increase, transferring command over resources from consumers and businesses to the Federal Government.

Causal Forces

Let us now turn to the basic causes of our economic problems. As you are all aware, the business and financial press has placed the blame for our economic disarray on a number of factors, the emphasis changing from time to time. Let me enumerate just a few that the press has cited most frequently: strong labor unions with power to raise wages and increase in costs of production; businessmen with power to administer prices; the world-wide food shortage which brought about a skyrocketing of food costs; the wage and price controls which distorted the allocation of resources and reduced incentives;

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the Arabs raising the price of oil; and general political uncertainty.

There is little doubt that each of these factors has had an impact on the state of our economy during the past year. However, we believe that it is wrong to attribute the bulk of our underlying economic problems to such irregular forces. Unions and management have sought to better their relative positions long before the current problems arose. Random forces such as droughts, institutional changes in exchange rates, changing consumer tastes, and revised legal rules have frequently had sharp short-run effects on relative prices and on the allocation of productive factors, but seldom have they influenced overall prices or overall production significantly over an extended period.

At the Federal Reserve Bank of St. Louis, we have conducted a number of studies into the basic cause of economic fluctuations. Considerable evidence has been developed indicating that the economy is basically stable and resilient. Despite monopolistic elements and frequent random shocks, the economy is not naturally subject to periods of great inflation or severe recession.

Our studies indicate that the course of monetary expansion has been the chief destabilizing factor underlying the problems I have just outlined. According to these studies, the trend

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growth of the money stock over four or five years determines the trend rate of inflation. In short, the basic or underlying rate of inflation is a monetary phenomenon.

Variations of a few quarters in the rate of money growth around the trend, as well as a shift in the trend rate of money expansion, have an important bearing on short-run cyclical movements in output and employment. On the other hand, after the growth rate of money is stabilized for a period, we have found that growth of the economy naturally returns to or near its productive potential.

Monetary Developments

A review of recent history helps illustrate this monetary impact. First, let us look briefly at the changing trends of monetary expansion since the early 1950s and relate them to price developments. From early 1952 until the fall of 1962 the money stock of the nation rose at an average 1.8 percent annual rate. From early 1952 to the end of 1965 (since money operates with some lag) prices, as measured by the GNP deflator, also rose at a 1.8 percent annual rate.

Then the pace of monetary creation began accelerating. From the fall of 1962 to the end of 1966, money rose at a 3.8 percent annual rate, and with a lag, general prices rose at a 3.7 percent rate from the end of 1965 to early 1969. Since late 1966 money has risen at an average annual rate of just over 6 percent, and overall prices have also risen at about a 6 percent

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annual rate since early 1969.

At times, it has been suggested that inflation resulting from rapid monetary growth, although not desirable, is the price that must be paid for encouraging a high level of output and a low unemployment rate. However, from early 1952 to the fall of 1962, when monetary growth was relatively slow, unemployment averaged 4.9 percent of the labor force. From the fall of 1962 to the end of 1966, when the trend money growth doubled, unemployment averaged 4.8 percent. Since 1966, with money growth having accelerated further unemployment has averaged 4.7 percent. In short, we have found that the trend growth of money is reflected over time in the trend of prices and has little sustained influence on production or employment.

Over shorter periods of time, however, fluctuations of money around the trend growth, lasting several quarters, have had an impact on output and employment with only a slight effect on price trends. For a period preceding each of the business cycle recessions in the post-war period, as well as before the so-called mini-recession of 1966-67, the rate of monetary growth slowed markedly. In each case, total real output declined and unemployment rose. Also, in each case the rate of inflation slowed somewhat, but at a high cost in terms of reduced production and employment.

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From the above casual observations, as well as from empirical studies of past developments in this country and others, several conclusions emerge. Monetary developments have been the chief cause of both inflation and, at times, high unemployment. They have been the cause of inflation when there has been an excessive long-run growth of the money stock. They have been the cause of temporarily higher unemployment when we have had a marked slowing in the growth rate of money.

Recent and Prospective Economic Conditions

Now, let us focus our attention on the monetary actions which appear to have the most relevance for current economic developments and which might be expected to bear heavily on economic activity in the near future. The chief monetary development of recent years has been the rapid trend growth of money. From early 1970, the money stock rose at about a 6.5 percent annual rate.

Experience indicates that with money rising at this rapid pace for such an extended period, the trend rate of inflation would be in the 6 percent range. We attribute the basic cause of this underlying rate of inflation to monetary growth.

In contrast to the persistence of a high rate of inflation, output has declined recently. Output, as measured by constant

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dollar GNP, had risen at a 4 percent trend rate from 1962 to 1972. From the first to the fourth quarter of 1973, growth in output slowed to a 2.1 percent rate, and in the first three quarters of 1974 it declined at a 4 percent rate. Reflecting the adverse developments in output, the level of unemployment has been rising recently, but the rise has been much less pronounced than the changed pattern of output.

There is considerable controversy regarding the basic causes for this turnaround in output growth. Some analysts content that the slowdown has resulted in large measure from factors influencing aggregate demand. Other analysts contend it has been due mainly to factors affecting overall supply.

Our view is that aggregate demand factors have contributed very little to the moderation and contraction of real product growth in 1973 and thus far in 1974. The dollar volume of total spending, as indicated by current dollar GNP, has expanded at a 9.5 percent annual rate since the last quarter of 1972. This compares with the 1962-72 average rate of 7.5 percent, and is only slightly below the rapid 10.2 percent rate during 1971 and 1972.

On the other hand, there have been numerous constraints placed on supply. For example, environmental requirements imposed on industry, in conjunction with price controls until last spring, led many firms to close down production

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facilities. Prices permitted on products did not generate a return sufficient to justify outlays to meet governmental environmental and safety requirements.

The oil embargo and the subsequent quadrupling of the oil price has reduced the growth of oil use. The depreciation of the dollar since 1971 has reduced the growth of importation of foreign goods and services and substituted for them more expensive domestic ones. All of these factors tended to reduce the resources available for economic use in production.

Also, as relative prices changed, reflecting the agricultural and oil situations, consumers, in an effort to maximize satisfaction, changed their spending patterns, but industry was not equipped to make the change as quickly. Hence, we found a surplus of certain standard-size automobiles while consumers have been seeking those that conserve on gasoline.

Furthermore, as overall demands rose rapidly, interest rates were driven up, and at higher interest rates, consumers desire more other goods and services relative to housing, which usually must be financed by sizable loans for long periods. As a result, we now have excess capacity in auto and housing production, while many other industries, such as steel, aluminum, machine tools, paper, chemicals, and petroleum have been at or near capacity operations with backlogs of orders. This has resulted in less efficient utilization of the reduced available resources.

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All of the above extraneous events thus led to a reduction in output and, with the trend money growth at about a 6 percent annual rate, to a sharply accelerated rate of inflation. It is important to note, however, that the non-monetary developments described above would produce a once and for all decline in output, and thus only a once and for all increase in the price level. In the absence of further external or institutional shocks, output growth should return to its historic rate and inflation should return to the pace consistent with monetary expansion. Meanwhile, the adjustments to the decline in resources take time to work themselves out, and produce a statistical picture of sharp decline in the rate of output growth and a sharp increase in the rate of inflation.

From a policy makers point-of-view, the acceptance or rejection of the analysis above is of utmost importance. If the decline and output was caused by supply constraints, then fiscal or monetary policy to stimulate aggregate demand further would result almost entirely in pure inflation without much improvement in the rate of output and employment.

Next, let us shift attention to more recent monetary developments. Since June of this year the reported rate of money growth has been at a 2.3 percent annual rate. We look at this development as an irregular fluctuation and do not assume that this slow rate of monetary expansion will be

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maintained for long. Experience indicates that an immediate slowdown in the rate of money growth to, say, about a 2 percent pace, if sustained for two more quarters, would cause a decline in output and employment.

Looking at a somewhat longer and more meaningful time period, the year to date, the reported average pace of money growth this year has been somewhat less than the 6 percent rate of 1973. If this rate of money growth were maintained over the next several quarters, the growth in total spending on goods and services would probably be around 8 to 9 percent next year. This would be consistent with a reduction in the pace of inflation from the recent double digit pace to a 6 or 7 percent range in the coming year. Also some resumption in real output growth could be expected. We are moderately optimistic regarding the relaxation of supply constraints on the economy. Price controls have been removed. Industry has made great strides adapting to the changes necessitated by the oil situation. Yet, despite these and other improvements, much more could be done to improve supply. Following the many recommendations made at the recent economic summit meetings, our Government could make a substantial contribution to further production growth by repealing laws and regulations which impede competition and efficiency and push up prices.

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In short, we anticipate some sluggishness in real production during the next six months, and after that some gradual improvement. This forecast might be accompanied by a further gradual increase in the rate of unemployment during the spring and summer of next year, before beginning to recede. Although this development alone is unpleasant it is much less severe than many recent projections.

Conclusions

In summary, major adjustments are taking place in the economy. Inflation is severe, and real output has been declining. The chief causal factor for inflation has been the acceleration of monetary growth which began in the mid-Sixties but has been particularly rapid since early 1970. But in addition, the economy has been hobbled by a number of Governmental actions, a chief one being the controls on prices. Also, a greater than normal number of exogenous shocks have been received, such as droughts and the rise in foreign oil prices.

It will not be possible to quickly achieve the goal of maximum potential real growth without inflation. Now is not the time to advocate quick solutions, fine tuning, or radically new remedies. Experience, both here and abroad, teaches that attainment of these two goals will only be achieved by disciplined monetary actions, facilitated by sound fiscal

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policies. Even then progress is likely to be slow, and both patience and fortitude will be needed. The Government could aid in shortening the adjustment period by eliminating many laws and regulations which interfere with competition and the efficient growth of output.

In the near future, we anticipate monetary growth will be moderate, as it has been so far in 1974. As Chairman Arthur Burns stated on October 10 to the Joint Economic Committee of Congress: "The policy that we have pursued represents a middle course. We have tried to apply the monetary brakes firmly enough to get results, but we have also been mindful of the need to allow the supply of money and credit to keep expanding moderately."

If this moderation in money growth does continue, the rate of inflation should gradually recede, no major recession should occur, and although we anticipate some further sluggishness, real output should not decline further and employment should rise.

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