1975 - INFLATION AND RECESSION - ONE VIEW

Remarks by
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It is good to have this opportunity to discuss with you my views of the business outlook. Although economic forecasters have not enjoyed much success in recent years, I regard this opportunity to present my views as a privilege as well as a challenge. It is most important at times like this, when there is even more uncertainty than usual surrounding the future course of the economy, that we publicly analyze and discuss the economic issues which affect all of us so closely.

The United States is currently suffering from the worst recession since the 1930's at the same time that price rises continue at an uncomfortable pace. Our present economic situation is most unlike any that I can recall, and I would like to discuss it with you before proceeding to the outlook. Like someone said about the past, I believe we are doomed to repeat the present if we do not understand it.

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RECENT MOVEMENTS IN OUTPUT AND PRICES

Unlike past recessions, the current period was not preceded by restrictive monetary and fiscal policy actions. Normally, a lack of knowledge of the future course of stabilization policies is the most important element clouding the economic forecaster's crystal ball. Even with perfect knowledge of the monetary and fiscal policies taken in 1973 and 1974, however, I doubt that anyone could have accurately projected that from the end of 1973 to the end of 1974 prices would increase 12 percent, production would fall 5 percent and the unemployment rate would rise from less than 5 percent to over 7 percent of the labor force.

What went wrong? Just about everything that could go wrong. Briefly, I will review some of the problem areas for you.

Some Factors Influencing Output and Prices in 1974

I regard the trend rate of money growth as the principal determinant of price trends, while short-run variations in money are manifested primarily in fluctuations in output. A trend growth of money of about 7 percent over the several years preceding 1974 was suggestive of price increases at about that same rate, a rate we obviously did not achieve in 1974. Although there was some deceleration in the growth of money prior to 1974, it was not enough to cause the fall off in output growth that we experienced. As I see it, the following factors were major contributors to the substantial economic discomfort experienced in 1974:

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1. Emergence of the Oil Cartel

Both the oil embargo and the quadrupling of imported oil prices adversely affected prices and output in the United States. Because our economy, although less than some others, is strongly dependent on foreign oil as a source of energy, we had little alternative to paying the higher prices required by the cartel. Prices rose not only for such items as gasoline and fuel oil, but also for finished goods and services which used oil as an input.

Our productive capacity, and thus output, was lowered not only because of factory closings related to the shortage of heat, but also because of shifts in relative prices. Higher gasoline prices, for example, discouraged the purchase of automobiles and suburban houses. Aggregate demand slackened as the public sought alternatives or postponed expenditures.

2. Counterproductive Legislation

In recent years, a number of well-intentioned acts have been passed by Congress with the effect of promoting inflation and hindering output growth. I number among these the wage and price controls, the environmental regulations imposed on firms and products, and the OSHA safety regulations.

Wage and price controls, imposed in August 1971, temporarily held down measured wages and prices, but the long-run effect was just the reverse. By 1973, controls were being circumvented in numerous

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ways, while promoting black markets, inefficiences, and cheating. By April 1974 when the controls were officially removed, firms and labor were pushing up prices and wages, respectively, in order to establish a higher base price or wage for the next occasion that controls might be imposed.

The environmental and safety regulations, whatever their influence on the environment and workers' safety, encouraged firms to increase prices and/or cut output in order to meet the higher costs involved. These regulations were passed prior to 1974, but their impact on prices, output and employment continues to be felt even today.

3. Other Influences

Crop losses both here and abroad operated adversely on prices of agricultural commodities; the continued depreciation of the dollar resulted in higher prices for imported goods ranging from wines to Volkswagens; capacity constraints reached in 1973 in such industries as plastics, chemicals, lumber and paper had a lingering effect on prices in 1974; consumer and business confidence was jolted by the disclosures of Watergate and the strains evident in the financial system as reflected in the failure of the Franklin National Bank.

The upshot of all these events was:

1. An absolute decline in the productive capacity of the economy;
2. A one-shot jump in the rate of inflation to about twice that consistent with the underlying, long-term money growth rate;

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3. A transfer of wealth from our country to the oil producing and exporting countries.

Monetary and Fiscal Policies in 1974

There was little change in monetary and fiscal policy actions, as reflected in the growth of the monetary base and Government expenditures, respectively, in 1974 from that of immediately preceding years. The monetary base, which is comprised of currency and bank reserves, historically has determined the trend growth of the money stock. The monetary base increased a little over 7 percent from January 1974 to January 1975, little different from the rate of growth over the preceding 4-year period.

The money stock, on the other hand, slowed to a 4.2 percent increase in the year ending in January. The growth rate over the seven-month period ending in January was even slower, at 1.4 percent. Currency drain, that is, an increase in the demand for currency relative to demand deposits, contributed significantly to the marked slowing in the rate of growth of money. In order to counter this negative influence on monetary growth, the Federal Reserve would have had to increase the monetary base at an even greater pace than the 7 percent trend rate observed.

Although the slower growth of money has operated to hold down production and employment growth in recent months, it has also set the scene for a reduction in inflationary pressures in 1975. I am not pleased with the recent developments in production and employment, but if a reduced rate of money growth were to be continued, we would be on the right track toward curbing the underlying source of the inflation problems which have plagued us for so long.

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Fiscal policy was probably somewhat more stimulative than monetary policy in 1974, judging by movements in Government expenditures and the Federal deficit. Federal Government expenditures increased at a more rapid rate in 1974 than in 1973, and the budget deficit (on the National Income Accounts basis) was slightly larger.

The widening of the gap between Government income and outlays, however, was not so marked as to put undue pressure on the Federal Reserve to support Treasury security offerings. Because I view Federal Reserve support of Government debt as the main channel through which the Government influences aggregate economic activity, I am pessimistic about the future impact of the large deficits that loom on the immediate horizon.

WHAT'S AHEAD IN 1975 AND BEYOND

The economic future, like the past, is dependent on those elements we can control, such as domestic stabilization policy, and those we can't, such as the weather, wars in other lands, and foreign economic policy decisions. Obviously, I will have more to say about the events we can do something about than those which lie beyond our reach.

The Immediate Outlook

Because of the train of events set in motion by earlier policy and nonpolicy developments, unemployment will be higher in 1975 than in 1974 and the inflation rate will be lower. What policy can do in this

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very short-run period is to alter the unemployment-inflation mix. I should point out that the available evidence suggests that over a period of years it is not possible to trade-off a given amount of unemployment for a given amount of inflation; in the past several years, despite rapid price rises, unemployment has reached levels as high as in the 1950s when there was very little inflationary pressure. But, if we want to talk just about the remainder of 1975, policy actions can exercise some influence over the unemployment - price split.

In my view, there are two important, interrelated questions to be answered if one is to gauge accurately the immediate economic future:

First, what will be the magnitude of the Federal Government's deficit, and second, how will it be financed. It appears that regardless of whose tax-expenditure program is enacted, the budget deficits for the 1975 and 1976 fiscal years will be the largest since the second world war. The magnitude of the deficit is important primarily because of the indirect pressure placed on the Federal Reserve with regard to debt financing.

As you probably know, the Federal Reserve historically has attempted not only to abet the Government's efforts to achieve full employment and price stability but has also attempted to keep interest rates low. Thus, when the Treasury has found it necessary to issue a large volume of debt to cover ongoing deficits, the Federal Reserve has often stepped in to purchase a sizable portion of Government debt in order to keep bond prices

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high and interest rates low. Unfortunately, despite initial success at keeping interest rates down, the bank reserves created in the process have led to an expanded money supply, greater spending, higher credit demand, rising prices and, ironically, rising interest rates. In other words, the expansion of the money supply to keep interest rates down has been self-defeating.

The larger is the deficit, the more constrained is the Federal Reserve to support it, thereby adding to the stock of money and fostering inflationary pressures. There is a close correlation between the small volume of debt issued in the 1950s and early 1960s, and the slow rate of growth of bank reserves, money supply and prices. Similarly, the large deficits encountered in the late 1960s and early 1970s are closely related to the rapid growth of bank reserves and the money supply, and the emergence of strong inflationary pressures in this period. Unanticipated inflation probably helped hold down the unemployment rate in the late 1960s, but the rapid price increases experienced since then have not only failed to curb unemployment, they have made it much more expensive to be one of the unemployed. It should come as no surprise to you, then, that I have little faith in the argument that massive Government deficits provide the best solution to our economic ills.

I will grant that given the current slack in the economy, a faster rate of growth in the money supply than the rate experienced since

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the middle of last year is desirable. But prolonged growth of the money supply at the double-digit rates some analysts are calling for would be a mistake because it would only lead to prolonged double-digit inflation.

I think it will be most difficult for the Federal Reserve to accommodate, say, a $50 billion deficit, without providing the spark for a new round of inflation at a time when inflationary pressures are at last beginning to recede. A $50 billion deficit would amount to about 3 percent of our Gross National Product, or a greater percentage than any observed in the post-war period. If the deficit actually expands to $100 billion (which is not impossible, given current legislative discussions), the deficit would amount to about 6 percent of GNP. If that occurs, the strains on our financial system in general, and the Federal Reserve in particular, would be enormous.

If the deficit can be held near the lower figure, with the bulk of the debt being absorbed by the capital markets, I believe we will observe moderate growth in the money supply in 1975, declining inflationary pressures, and an unemployment rate about the same as or somewhat lower than its present magnitude. A deficit near the $100 billion mark might lower the unemployment rate slightly, while wreaking havoc in the domestic and foreign money markets and providing the impetus for a new wave of inflation at even higher rates than those observed heretofore.

Long-run Considerations

As you have probably gathered from the above remarks, I am more concerned about the long-range trends and the viability of our economic system than with how we can obtain a slightly better outlook for unemployment in any one given year. I am concerned about the wealth losses our country has experienced and continues to experience in association with our debts

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to foreign oil producers. I am concerned about the international stability of the dollar and the future of the international payments mechanism in the face of governmental efforts to maintain artificial exchange rates. But, most of all, I am concerned about the implications of the ever-expanding role of Government in our free-market society.

The Federal Government budget rose from 3 percent of GNP in 1929 to 21 percent in 1974. State and local government spending has been rising at even more rapid rates than Federal Government spending over the past ten years. Despite this, our economic problems are worse than at any time since the Great Depression. The Government, to cite only a few of its laws, has attempted to guarantee minimum wages to those who work, a minimum income to those who don't, financial security for the elderly, medical security for the sick, high prices to the farmer, low prices to the consumer, low interest rates to home owners and environmental controls to environmentalists.

All of these programs represent well-intentioned efforts to grant all things to all people. Unfortunately, many of these programs have produced undesirable side effects. The catalytic converter required by recent environmental laws has been found to emit an acid mist perhaps as dangerous in the atmosphere as the pollutants it was designed to curb; low ceilings on mortgage rates and rates payable at savings and loan associations have tended to dry up mortgage money and actually act as a depressant to the housing sector; price controls discouraged profits and

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incentives to produce such necessary goods as oil in this country. A complete list of what was once good intentions that have gone awry would be very lengthy.

As far as the income guarantees are concerned there is evidence that they have contributed to a reduction of work incentives and thus, to lower potential output. These admirable programs have added to inflationary pressures not only by way of discouraging production, but also by encouraging a larger deficit and an expanded money supply. I will not attempt to enumerate the acknowledged ills of inflation, of which you are all aware, but I would like to cite a statement by J.M. Keynes, the English economist who provided the theoretical foundation for massive Government intervention in the economies of the western world:

> There is no subtler, no surer means of of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose.[1/]

SUMMARY

We face serious problems indeed in today's economy. Every period in our economic history is unique, but the current combination

1/ J.M. Keynes, The Economic Consequences of Peace (London, 1919), P. 220

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of inflation, and recession, together with higher costs and reduced availability of energy sources, poses an unusual challenge. If we choose to attack these problems with short-run solutions, relying on Government edicts to handle one, then the other, I believe we may be headed for grave difficulties in the future. If, however, we take the long view and do not succumb to the crisis of the moment, I feel our economy can bounce back stronger than before. But we must strive to restore free markets and individual incentive in the determination of our economic future or the golden goose is dead.

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