GOVERNMENT POLICIES AND THE ECONOMIC OUTLOOK

Speech by

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It is good to have this opportunity to discuss with you my views on Government policies and the outlook for the United States economy over the next few months. I will begin by examining the current state of economic activity. Then I will discuss the outlook for the general economy and the assumptions on which my outlook is based. Finally, I will comment on the trend toward an expanded Government role in our basically free-market economy.

Let us begin by examining some factors which led to the current state of the economy. 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 inflation 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 moderately 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. However, 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.

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 spending. Conversely, a slowing in the rate of money growth has been followed by a pause in spending growth. 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.

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. Over the past year and a half, the performance of the money stock has been much more uneven than usual. The money stock grew at a 10 per cent annual rate the first seven months of 1971 and then slowed to virtually no growth during the last five months of the year. Since December money growth has again picked up at about an 8 to 10 per cent rate.

In my view monetary growth will be the most important

factor influencing the course of spending throughout the remainder of 1972, but let me hasten to add that fiscal actions may also play an important part.

The Federal deficit in the fiscal year ending June 1972 (on a unified accounts basis) was estimated to be $38.8 billion. Although it is now evident that the deficit will be less because of overwithholding, 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 provides much of the basis for the very optimistic economic forecasts which were being made earlier this year.

These optimistic projections included: (1) about a $100 billion rise in total spending in 1972 compared to a $75 billion increase in 1971; (2) a doubling of real product growth from 3 per cent in 1971 to 6 per cent; (3) a decline in the rate of inflation from 4.7 per cent in 1971 to around 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.

Are these figures still 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. 1/ 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.

Second, money growth must be very stimulative for the remainder of the year. A 6 per cent rate of increase in the money stock (the average of the past four years) during the rest of 1972 would not likely 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 per cent or higher, the standard forecast for GNP and output could 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. For many years, changes in the trend growth of

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1/ Net liquidity basis.

money have been closely followed by similar changes in the trend growth of prices. 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.

The third major condition required for fulfillment of the standard forecast is that 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 not been encouraging. Let me spend a few moments discussing this very important attempt of the Government to subdue price and wage pressures.

There are a number of reasons why the price and wage controls apparatus, instituted at the time that it was, could be expected to achieve marked initial success. First, there was last August, and there is still, considerable slack in the economy.

Second, monetary actions have not been especially stimulative over much of the period of controls. Given the

usual lags with which such actions affect prices, I would surmise that monetary actions have not yet seriously interfered with the workings of controls. Third, the wage calendar encountered by the Pay Board since last fall has not been heavy. In fact, few of the more powerful unions have had wage contracts up for negotiation over the period of controls.

Finally, the public was ready for controls. The polls indicated last summer that peacetime price and wage controls were an idea whose time had come. Consumers, businessmen, even some unions supported and actively campaigned for their adoption.

Now, what has happened to prices and wages since last August? Consumer prices rose at a 3.3 per cent rate from last November to April, compared with a 4.1 per cent annual rate of increase in the six-month period preceding controls. The wholesale price index increased at a 5.1 per cent rate from November to April after rising at a 4.7 per cent rate in the six months preceding the imposition of controls. The industrial component of the wholesale price index rose 4.1 per cent after November as compared to 5.4 per cent the prior six months. The question to be asked here is how much credit should controls receive for the slowdown in some prices.

The implicit price deflator projections of six econometric models (including our own) made just prior to the freeze averaged a 4.3 per cent increase from the second quarter of 1971 to the first quarter of this year. 2/ The survey of approximately forty forecasts made by the American Statistical Association last summer indicated a 3.5 per cent rate of increase over the same time period. The actual rate of increase of the deflator was 3.5 per cent over the three quarters ending in the first quarter of 1972, with most of one of the three quarters being under complete freeze. Thus, I would contend that the contribution of the controls program to curbing price increases has been marginal, at best.

I would also suggest there is little evidence that controls have had much effect on wage movements. Both manufacturing hourly earnings and the hourly earnings of the non-farm, private sector of the economy have increased faster since the end of the freeze than they did in the six-month period preceding the freeze. 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.

2/ Data obtained from the National Industrial Conference Board Statistical Bulletin, August 1971.

If we can presume then, that controls have made little contribution to price and wage stability, have they done any harm? My guess is that little serious damage has been done thus far. Although considerable additional uncertainty about the future course of the economy (to include wages, profits and interest rates) has probably been generated, I do not think there has yet been sufficient time for serious side effects to develop. The danger is that, in surveying the lack of effectiveness of the controls program, the authorities may not eliminate this unique peacetime incursion into price and wage setting, but might expand the invasion.

If the latter turns out to be the case, the U. S. will simply be following the pattern set by a number of other countries which adopted such policies in the postwar period. We will not, however, be expanding the controls program in imitation of any long-term success enjoyed abroad or in this country during our wartime employment of controls. One prominent study which surveyed the postwar experience of West European countries with controls up until the late 1960s found that ". . . periods of effectiveness were typically short-lived; they were frequently followed by wage or price explosions which sometimes blew up the policies themselves." 3/ Moreover, the London Economist recently reported that of twelve European countries relying on

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3/ Lloyd Ulman and Robert Flanagan, Wage Restraint: A Study of Income Policies in Western Europe, (1971), p. 223.

price-wage control measures in 1970 and 1971, most found them of little or no help in curbing inflation.[4/]

Our own experience with a sweeping, complicated controls program such as we had in WWII was not a pleasant one. Despite the fact that the war served to pull many Americans together in support of the program, there were shortages, rationing, blackmarkets, inequities, and thousands of control administrators who could have been employed more productively elsewhere. In addition, prices and wages rose after the war back to where they probably would have been in the absence of controls.

There is little indication as yet that the current controls have been severe enough to create problems similar to those encountered in the 1940s. However, the trend toward increased escalation of Government interference in private wage and price decisions is disturbing. During the war, controls were used as one mechanism for re-allocating resources. By restraining private demand, the controls facilitated the transfer of goods and services from the private to the Government sector of the economy. Today, there is no need for such a transfer, but the reallocation process is at work, just the same. In this case, the reallocation of goods and services is from those whose incomes or profits are effectively constrained to those

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4/ New York Times, May 7, 1972

free of the constraints. This transfer of resources, compared to the free market's allocation of resources in accordance with one's contribution to output, is not only inequitable, but inefficient. When controlled, prices and wages cannot easily signal shifts in demand or supply, which are necessary to guide resources to their most productive employment.

The signals are often misleading when the rules of the controls are changes, as they have been numerous times over the past few months. The rules now favor, in addition to the agricultural sector, small firms of all sorts. The Price Commission has been rapidly expanding its staff in order to restrain the prices and profits of the country's larger firms through fines, exhortation or red tape, Profits, however, have not been of sufficient magnitudes to warrant such restraint.

Profit margins are currently the lowest for any comparable period at this stage of an economic recovery since the 1940s. Corporate profits after tax as a percentage of GNP are similarly low in comparison with previous recovery periods. The point is that the current economic recovery has been rather weak, and stronger attempts by control forces to hold back profits seriously endanger our continued prosperity. I am not only talking about endangering economic growth, which most analysts would link with profits and investment,

but inflation control as well.

If there is little inducement for a firm to increase its profits, then there will be little inducement for it to increase productivity by cutting costs, seeking new areas of investment or expanding its research and development. Without gains in the rate of growth of productivity, which are being so avidly encouraged by various Government program spokesmen, the job of halting inflation becomes much more difficult. Those gains we are not getting.

Another possible move by the Government which would have adverse effects on productivity, investment or inflation is the Burke-Hartke Bill which would reverse our free trade policies through import quotas and controls on U.S. foreign investment. Passage of this bill would curb profitable investment opportunities to U.S. businessmen and invite retaliation by our trading partners. The result would probably be a decline in consumer's welfare since they would have fewer goods and services from which to choose, and higher prices paid for the protected U.S. goods.

Another perhaps well-meaning, but ill-considered piece of legislation is the proposed jump in the minimum wage from $1.60 an hour to $2.00 an hour. The minimum wage increase would not only have an adverse employment effect on many of our disadvantaged, inexperienced or

handicapped workers, but would also encourage an inflationary upward shift in the structure of all wages.

These programs, if implemented, would make the task of the monetary and fiscal stabilization authorities more difficult, but not impossible. There is no evidence so far as I know that the economic growth, inflation, and employment goals of the country cannot be achieved by proper stabilization policies, despite growing Government encroachment in private wage, price and employment decisions. Recent research at the Federal Reserve Bank of St. Louis indicates that a full employment level of output is consistent with price stability given a moderate long-term trend growth of the money supply.

Our research suggests that changes in the trend rate of monetary growth lead changes in the rate of growth of prices by several years. A 1.7 per cent growth rate of the money supply over the ten year period ending in 1962 led to price stability from 1952 to 1965. When the rate of growth of the money supply picked up to a 3.7 per cent rate from 1962 to 1966, price increases accelerated to a 4 per cent rate from 1965 to 1969. The money supply rose at a 5.7 per cent rate after 1966 and prices increased at a 5.4 per cent rate from mid-1969 to the summer of 1971.

Thus, it is my view that the basic cause of inflation is excessive monetary growth and the application of price-wage controls can only treat the symptons of such inflation. The expansive monetary and fiscal policies which we have observed so far this year have been designed to stimulate growth and lower the rate of unemployment, while price and wage controls have been expected to curb inflationary pressures. I believe this dichotomy of responsibility for growth (or employment) and inflation may lead to serious economic problems. The achievement of full employment with price stability would be enhanced by focusing, not on direct government intervention in the market place, but on prudent monetary and fiscal stabilization policies.

In conclusion, I would like to cite a statement from a speech I delivered on possible solutions to inflation one year ago, or two months before the imposition of controls. ".... if we attempt to halt the inflation through direct controls, I fear that we will not exercise the necessary monetary restraint and will lose much of the gain achieved from the slower rate of money growth in 1969. In addition, such controls will mean further losses of freedom for individual action which has through the years provided us with the world's most

efficient economy."[5/] I believe that statement still holds.

5/ Darryl R. Francis, "Proposed Solutions to Inflation -- Effective and Ineffective," a speech given at the Mississippi School of Banking, Oxford, Mississippi, June 13, 1971 and reprinted in the July 1971 Review of the Federal Reserve Bank of St. Louis