THE ECONOMIC OUTLOOK

Speech by

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I am pleased to have this opportunity to present to you my views regarding the economic outlook. My remarks will first be devoted to a brief presentation of the general outlook. Then, I will discuss some of the problems facing the nation because of a Federal budget which is generally acknowledged to be "running out of control." Decisions made in answer to these budget problems will have a great effect on the course of our economy over much of the 1970's.

Let us now examine the general economic outlook for the next few quarters. The President's Council of Economic Advisers, in their Annual Report of last January, projected a rapid advance in total spending (GNP) for 1972. They projected strong real product growth and a significant decline in the rate of inflation by the end of the year.

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Substantial progress has been made in achieving this optimistic forecast. Total spending has advanced rapidly since late 1971, largely in response to stimulative monetary and fiscal actions taken earlier. Growth in the money stock has been uneven, but has averaged a 6.6 percent annual rate since early 1971. In comparison, money increased at a 4.5 percent rate from early 1969 to early 1971. Fiscal actions have also been expansionary, with Federal expenditures rising at a 13 percent rate since the first quarter of 1971, substantially faster than the 7 percent rate of increase in the previous two years.

A significant portion of the recent advance in total spending has been manifested in real product growth, with the associated rate of price inflation being moderate. Real product growth accelerated to a 7.5 percent annual rate from third quarter 1971 to second quarter 1972, more than triple the increase in the previous year. The rate of inflation, as measured by the GNP price deflator, has been at about a 3 percent rate since mid-1971, compared to a 5 percent increase in the preceding year.

The rapid rise of real product has fostered a strong advance in employment. Payroll employment has increased at a 3.4 percent annual rate since last fall, compared to a 1 percent rise in the previous year and a trend rate of growth of 2 percent from 1957 to

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1971. The relative strength of these employment gains is noteworthy since the population of working force age is estimated to be growing at less than a 2 percent annual rate. Total employment in mid-summer was over 64 percent of the population of labor force age, higher than in the prosperous year of 1965.

Given these developments through the second quarter, substantial progress was made in the first half of the year toward realizing the Council's goals for 1972. Moderated growth of both total spending and real product in the final six months of the year, and continuation of price increases at about the average rate of the past two quarters would be consistent with attainment of the goals.

In evaluating the healthy turn of the economy thus far in 1972, I will now present briefly my views regarding the prospects for sustaining such a rapid expansion of output, the advisability of relying solely on monetary and fiscal actions to bring the unemployment rate down much further, and the contribution of controls to reducing inflation.

First, the very rapid growth of real output in the first part of the year is probably not sustainable over the longer-run. There is some evidence that a slowing has already occurred. For example, industrial production has grown at a 4 percent rate since April, down from a 14 percent rate over the preceding four months. Pay-

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roll employment has risen at a 2.5 percent rate since April, after rising at a 4.6 percent rate from December to April. These slower rates of increase are desirable, I believe, because they are more consistent with preserving the gains that have been made in slowing the rate of inflation than would be an attempt to continue the faster growth rates experienced earlier in the year.

Some will criticize this slower rate of employment growth because the unemployment rate has fallen only to the neighborhood of 5.5 percent. These critics cite as a desirable goal an unemployment rate of 4 percent or less. As laudable as such a goal may be, these critics overlook the costs of attaining such a target through the use of overall economic stimulus. Post-war experience demonstrates that whenever the unemployment rate has moved below 5 percent, inflation has become a serious problem. Given the structure of our labor markets and the way they function, using monetary and fiscal actions exclusively to achieve significant further reductions in unemployment runs a serious risk of renewed inflationary pressure.

On this point I am in agreement with the Chairman of the Council of Economic Advisers who, in an interview for First National City Bank last August, pointed out that "there are a number of other policies which may be involved in getting the rate of unemployment down." He indicated that what he had in mind was various types of manpower programs.

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Apparently there was a realization of this point when price and wage controls were instituted thirteen months ago as part of a program designed to promote economic recovery and a slowing of inflation. Some have cited, as evidence of the contribution of these controls to price stability, the 3 percent increase in the consumer price index in the year ending with August. This was down from a 4.5 percent increase in the year prior to controls. It is not clear whether this reduction in the rate of inflation has been due to controls or to natural economic forces set into motion by the monetary restraint of 1969 followed by moderate growth in money in the period immediately thereafter.

I tend to place emphasis on this latter development. Inflation reached a peak in early 1970. In February of that year the consumer price index was over 6 percent higher than a year earlier. The rate of inflation has been decelerating since then, declining to 4.5 percent in the year ending August 1971 when the controls were imposed. The deceleration in consumer prices was only a little more in the following twelve months than in the year prior to controls.

With regard to the economic outlook for the balance of this year and through 1973, most private economic forecasters expect a continuation of strong economic expansion through the end of next year. They do not, however, expect the expansion to

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continue at the rapid rates of the first half of 1972. These forecasters generally do not expect much further improvement in the rate of inflation. In fact, many forecast the reemergence of accelerating inflation by the last half of next year.

I am in agreement with the general contours of output and price movements projected by most private forecasters. The course of monetary expansion, especially that related to Federal budget developments, can alter this outlook considerably, however.

Our research indicates that the rate of expansion of the money stock over a period of five or more years is the major determinant of the rate of inflation. This research also indicates that a change in the rate of money growth for a period exceeding two quarters exerts a significant short-run, but temporary, influence on growth in output and employment. So let us look at some implications of recent monetary developments in light of these findings.

Money has grown at a 6 percent trend rate since 1966. Our research indicates that the rate of inflation in the neighborhood of 4 percent expected by many forecasters for late next year is consistent with this trend in money growth. Over a shorter period, money has increased at a 9 percent rate thus far in 1972. If this rate of growth were to continue much longer, I would expect inflation to intensify more next year than currently forecast. On the other hand, if we were to revert abruptly to a lower

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growth rate of money, I would expect less expansion of output next year from that expected by most forecasters. You can see the problems facing those who have responsibility for promoting both high employment and price stability.

These problems are further complicated by the outlook for the Federal budget. The unified budget moved sharply from a surplus in the fiscal year 1969 to a deficit in fiscal year 1971. This shift from surplus to deficit reflected virtually no growth in receipts while expenditures increased $27 billion. If the economy had remained at a high level of resource utilization, and if no change in tax laws had occurred, receipts would have been about $37 billion higher than was realized. More than half of this short-fall in receipts resulted from tax changes following elimination of the income tax surcharge and the Tax Reform Act of 1969. The remainder of the short-fall was due to the slowing in economic activity during the recent recession. Some have cited this move toward budget deficits, which was augmented by further tax reductions in the Revenue Act of 1971, as a desirable development in view of the softness in the economy.

Once getting into this situation, what are the prospects of getting out of it now that economic activity is expanding quite rapidly? In the fiscal year ending June 1972, the deficit was $23 billion. With increased expenditures for existing programs <u>only</u>,

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including recently enacted revenue sharing, and revenues from existing tax laws, it is generally estimated that the deficit will be about $35 billion in the present fiscal year. The proposed ceiling of $250 billion on expenditures would reduce this deficit to around $27 billion. This ceiling would thus contribute little to eliminating the deficit.

Looking further ahead, we estimate for fiscal year 1975 that existing spending programs and taxing provisions will result in a minimum deficit of $15 billion if we have full employment. I believe, along with many others, that the Federal budget is virtually out of control.

Let us now examine the alternatives which face us as a result of this bleak budget picture. An obvious step would be to get the budget back into balance this fiscal year by cutting Government expenditures about 13 percent. This si considerably more than the 3 percent spending cut implied by the proposed ceiling. In view of the concern expressed over the proposed $250 billion ceiling and the ever mounting pressures for expanded programs, such a marked reduction in spending is unlikely.

A budget balance could also be achieved by increasing taxes. This would require a 15 percent increase in Federal government tax collections from all sources. This alternative would also be difficult to achieve in view of the pressures for tax relief. Further-

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more, it may not be desirable for longer-run control of the budget. I am afraid that expansion of revenues to meet present levels of spending would tend to reduce the prospects for close evaluation of the appropriateness and effectiveness of existing spending programs. Furthermore, such an expansion would tend to establish a bad precedent for evaluating the long-run costs of new programs.

If the prospects are not very good for a marked reduction in forthcoming deficits, what are the remaining alternatives? The inflationary impact of the deficits could be reduced considerably by financing the entire deficit by borrowing from the public. To attract the funds required from competing uses would, however, result in a marked rise in interest rates. If past experience is any guide, such a development would be strongly opposed by large segments of the general public and by many politicians.

In the face of such opposition, there would be considerable pressure to finance the deficits by another alternative, that is by monetary expansion. This is what happened in the 1965 through 1968 period when the Federal Reserve System attempted to resist an upward movement in interest rates by acquiring an ever increasing proportion of a constantly growing national debt. Just as in this earlier period, the rate of monetary expansion would accelerate under this alternative, resulting in accelerating inflation and eventually in higher interest rates.

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In such a case, another alternative is to rely on price and wage controls to reduce the rate of price increase. Such measures, however, merely treat the symptoms of inflation and not its underlying cause, which is a rapid trend rate of monetary expansion. With a rapid rate of monetary expansion, controls would have to become progressively more restrictive if continued progress were to be made in reducing the rate of price increase. Past experience, both here and abroad, indicates that price and wage controls have not been very effective in reducing the rate of inflation for any extended period of time.

Some have given up on the fight against inflation, and recommend still another alternative which I find to be particularly objectionable. They suggest that the best course of action at this time is to maintain the present trend rate of money growth and to learn to live with the current rate of inflation. They argue that once a rate of inflation becomes fully anticipated, as may be the present situation, individuals can take steps to protect the purchasing power of their income and savings from the ravages of inflation. On the other hand, they argue that the short-run costs in terms of reduced output and employment, which would be expected to accompany steps taken to reduce inflation further, would be too great to bear.

I do not accept this alternative. I see no evidence that our labor, commodity, and financial markets are such as to permit all

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individuals equal opportunity to protect their purchasing power from erosion by inflation. Furthermore, it is not just the case of holding the rate of inflation constant that the country now faces, but the more likely case of accelerating inflation. There is no assurance that the economic policy errors of the past which caused the present inflation will not be repeated. If such errors were repeated after we had decided to try to live with the present inflation, the result would most likely be an even higher rate of price advance.

There is one final alternative that I would like to present. This alternative is learning to live with economic stability without inflation. Our research indicates that it is possible, with appropriate monetary actions, to achieve output and employment growth at our economy's potential without inflation. I see no reason to settle for anything less than such a goal. But I realize that attaining this objective in the near future would entail some temporary, transitional costs in terms of somewhat slower growth in output and employment for a while.

The big question remains whether or not our people have the intestinal fortitude to bear these short-run costs. These costs of curbing inflation were borne in the late 1950's and early 1960's. As a result, our economy began to experience economic stability without inflation in about 1964. Then a stabilization mistake occurred with the acceleration of government spending in the mid-1960's.

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Steps were taken to correct this mistake by a sharp reduction in the rate of monetary expansion in 1966 and again in 1969. Twice, a large portion of the transitional costs of controlling inflation was borne. In each instance the stage was set for a resumption of output growth at our country's potential without inflation, if money growth had been resumed at a lower trend rate. Following 1966, however, prospective short-run costs were deemed to be too great and the trend rate of monetary expansion was accelerated. Following 1969, there was concern over the short-run costs that had occurred, and money growth was resumed at a moderate rate for a while. But then it accelerated and the trend rate established earlier was not altered.

In conclusion, the outlook for 1973 and beyond is for continued strong growth in output and employment. Given the Federal budget outlook, however, there is also a very pessimistic aspect to the outlook. Unless courageous steps are taken to bring government spending under control, there is a great likelihood of rising taxes, higher interest rates, more inflation, or tougher controls -- separately or in various combinations.

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