ECONOMIC PROSPECTS FOR 1974

Remarks by
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It is good to have this opportunity to discuss with you our assessment of the economic outlook for next year. At the present time, development of the outlook is subject to greater uncertainty than usual. This increase in uncertainty stems from a number of developments which have grossly distorted the normal operations of our economy. Some of these developments are: a relatively long period of high inflation, the use of price and wage controls in an attempt to contain inflation, environmental requirements imposed by government, and uncertain energy prospects related partly to the recent curtailment of the amount of oil we import from the Middle-east.

Since future economic activity depends in part on conditions of the past, I will first assess the current state of the economy. Such an assessment provides the starting point for developing the economic outlook. In addition, it provides useful information regarding the nature of existing distortions which have introduced added uncertainty regarding the outlook. After this examination, I will present our view of the most likely course next year of output of goods and services and of the rate of inflation.

So, let us begin with an examination of the current state of the economy. Growth of output of goods and services has slowed markedly since early this year. Output, as measured by constant dollar GNP, increased at a 3 percent annual rate from the first to the third quarter, substantially less than the 6.5 percent average rate of increase over the preceding two-year period. There is considerable controversy regarding the reasons for this slowing in output growth. Some analysts contend that the slow-down is due in large measure to factors influencing aggregate demand, while other analysts contend it is due mainly to factors influencing over-all supply.

Our view is that aggregate demand factors have contributed very little, and likely none, to the moderation of real product growth. The dollar volume of total spending, as measured by current dollar GNP, grew at a 10 percent rate during the last two quarters, about the same as in the preceding two years. We, therefore, must conclude that the slowing in growth of output of goods and services reflects mainly the influence of factors impinging on supply. Both resource limitations and serious distortions in productive processes introduced by government actions have been restraining influences on growth of output.

As the economy moves to a state of high utilization of resources, sustained growth of output is limited by the long-run growth of resources. There is evidence that our economy presently is at a point of a high level of resource utilization. For example, the Federal Reserve's capacity utilization index of key major materials such as steel, aluminum, petroleum, and lumber, indicates that these industries are currently operating at over 96 percent of capacity, the highest level attained in twenty-five years. Employment data indicate a high level of utilization of labor resources. The number of people holding jobs relative to the number that are of job-holding age is currently at a post-war high of 65 percent. Economists have estimated that at a high level of resource utilization, such as appears to exist at the present time, growth of output of goods and services cannot be sustained for very long at a rate in excess of 4 percent.

This rate of output growth, however, may be even lower than 4 percent today because of distortions in the process of production resulting from recent government actions. For example, environmental requirements imposed on industry, in conjunction with price controls, have led many firms to close down some of their production facilities. Prices permitted on their products do not generate a return sufficient to justify outlays to meet government environmental requirements. Price controls have also resulted in many firms concluding that it would not be profitable for them to expand their productive capacity as would normally be the case. In addition, price controls have induced many producers to shift the composition of their output from low profit to high profit items. Such shifts have tended to limit the level of production of many firms which use as raw materials the items no longer being produced. Consequently, growth of output of these firms is slower, not because of lack of demand, but because of lack of raw materials.

In view of our economy operating at a high level of resource utilization and taking into consideration government actions tending to limit growth of production further, it should not have been unexpected that growth of output slowed recently to a rate of 3 percent. Furthermore, with continued high rate of growth in total spending, it should not have been surprising, under these circumstances, that inflation continued to remain at a high rate.

In examining the present situation regarding inflation, we must consider its basic cause. According to our view, inflation is a monetary phenomena. Let me elaborate on this point. A rapid rate of money growth over a period of a year or so fosters a rapid rate of increase in total spending. If there are unused resources, it is primarily output which first expands in response to rapidly growing total spending. But once a high level of resource utilization occurs and growth of output is limited by capacity considerations, continued rapid growth in total spending is accompanied by rapidly rising prices.

Let us now apply this proposition to the current situation regarding inflation. The United States' money stock, defined as demand deposits and currency held by the public, grew at a 2 percent average annual rate from 1952 to 1962; it then increased at a 4 percent rate to 1966, and it has risen at a 6 percent rate since then. The general price index has moved in approximately a similar manner. We thus conclude that the average rate of inflation should not be expected to lessen until a lower trend rate of money growth occurs.

While inflation is basically a monetary phenomena, other factors can produce temporary movements in the price level from that consistent with a prevailing trend rate of money growth. Some recent events have caused such outbursts of price increases. One event was the poor crop harvest last year. Another factor augmenting U. S. price movements was the devaluation of our currency relative to that of most other industrial countries. Devaluation has stimulated the export demand for U. S. goods and services, thereby increasing the prices of many goods. The other side of the devaluation coin has been higher prices of our imports. More recently, the energy situation has resulted in increases in some prices.

The influence of such events on the rate of inflation tends to be temporary, however, and the basic cause of inflation should not be ignored. I find it particularly disturbing that attention has been focused mainly on these temporary influences in developing so-called solutions to the problem of inflation, rather than on the basic cause -- a continued rapid 6 to 7 percent trend rate of money growth.

Controls imposed on prices of individual products and on wages is an example of a misdirected solution. In place of actions to reduce growth in total spending, such controls have been of little help in reducing permanently the rate of inflation. In fact, controls have frequently achieved just the opposite effect from that intended. Let me give you just one example. The Cost of Living Council earlier this year tried to hold down increases in food prices by fixing a low price of fertilizers relative to the world market price. The result was increased sales of fertilizers to other countries at a high price and fewer sales of fertilizers to our own farmers at a lower price. By reducing the amount of fertilizer available to our farmers, the price controllers risked causing smaller crop yields per acre, reduction of output of agricultural commodities, and still higher food prices. Fortunately, the controllers -- after some time -- came to realize the potential danger and removed the ceiling.

A major fallacy of imposing ceiling price controls on any good at a time of rapid growth in total spending is that production of that good is not encouraged to rise, and in many cases, may be encouraged to fall. The present energy situation is a case in point. Many have recommended rationing at controlled prices as the main solution to the energy crisis. An alternative to rationing is to allow prices of various sources of energy to rise according to free market forces. Such a rise in price would help the immediate situation. Higher prices would induce users to reduce their consumption of energy from sources in short supply and would induce producers to use available sources more intensively.

Moreover, if energy prices are not allowed to rise to their market-determined level, there could be a longer-run adverse impact. There would be little incentive for energy producers to step up the pace of exploration, to develop new sources, and to build new processing plants. In other words, in a situation of continued rapid growth in total spending, price-fixing tends to work against long-run increases in production. Consequently, energy rationing today as an alternative to price increases, very well could result in prolonged shortages and continued rationing.

I now turn to our assessment of the economic outlook. There is considerable evidence that both prices and output respond to policy actions with a fairly long lag; therefore, policy actions over the immediate past will have a major influence on the outlook for next year. Monetary actions have been about as stimulative on total spending in 1973 as in 1972. It now appears that for 1973 money stock will have grown at a rate only slightly less than the 7.5 percent rate recorded for 1972. Federal expenditures in 1973 appear to be rising at a rate moderately less than the 12 percent rate during the previous two years. In addition to the influence of past policy actions, the course of monetary and fiscal actions during early 1974 will also influence the economic outlook for the year.

Given the nature of the monetary and fiscal actions in 1973 and assuming a reduction in the growth of money to about a 5 percent rate (this is an assumption and is not a forecast) and a continuation of the recent moderate slow-down in growth of government spending, I foresee in 1974 continuing slow growth in output and little reduction in inflation.

Total spending would most likely grow at about a 7-8 percent rate, a little less than in 1973. With somewhat slower growth in total spending, and holding aside the energy situation for the moment, I would expect continuation of the rate of output growth in the neighborhood of 3 percent. Unless monetary and fiscal actions become much more restrictive than I have assumed, or if shortages of critical industrial commodities and energy grow considerably worse than at present, there would exist little possibility of a recession in 1974.

I expect that inflation will continue to rise at a rate not much lower, if at all, than that prevailing in 1973. Some analysts believe that the slower projected growth of output, by itself, would help reduce the rate of inflation. Such would be the case if there were a marked reduction in the rate of increase in total spending. But we do not believe that such a marked reduction is likely next year, given the continued rapid growth in money during 1973. In addition, even if total spending did grow at a markedly lower rate, it would take considerable time for the response of the price level to be of a significant magnitude.

Up to this point, our view of the outlook has not taken into consideration the energy problem. At present it is too early to project the outcome of this situation, either in 1974 or in future years. Too little is known about its magnitude, about plans of government and others for coping with it, and about the reactions of individuals and firms to programs cutting back use of energy. Many have predicted, however, that there will be additional upward movements in prices, as costs rise, and reduced growth in output due to a lack of energy. Some analysts have estimated that the reduction in the rate of output growth will be about one to two percentage points. It is my view, however, that the energy problem will become a crisis only if government decides to rely more on rationing or tax gimmicks as a solution, and less on allowing a free market to operate.

In conclusion, it is our view that the United States in 1974 will not achieve its economic goals of reasonable price stability and economic growth consistent with long-term growth in resources and productivity. Moreover, what happens in the future depends critically on fiscal and monetary actions which affect spending for goods and services, and on governmental actions which either encourage or discourage expansion in production.

In a relatively short-run, the energy problem may have dramatic effects on economic activity. The handling of the problem will determine whether it will be short-lived or prolonged. As I have mentioned before, a preoccupation with the problem of how to allocate energy, without actions to increase production, will simply extend shortages for years to come. The beef example of last summer is a case in point and current energy shortages are not dissimilar from last summer's episode with the freeze on beef prices. Let us hope that the lesson of last summer has been learned. It is unfortunate, however, that the energy situation has diverted attention from the distortions caused by price controls.

The tragedy of the today's situation is that many of the present problems could have been avoided through earlier policy decisions oriented toward achieving long-run solutions rather than toward meeting the so-called "pressing needs" of the moment. I am not persuaded, however, that the lessons from past experience have been sufficiently understood to prevent the repetition of similar difficulties in the future.