THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

August 5, 1968

MEMORANDUM FOR THE PRESIDENT

Subject: Troika Review of the Economic and Budgetary Outlook

1. The Troika staff has completed a detailed economic and budgetary projection for fiscal year 1969, taking account of the effects of the Revenue and Expenditure Control Act.

   . The expenditure projections reflect

     -- a Vietnam add-on of $2.6 billion over the January estimates

     -- a rise of $1.0 billion in the exempted items, due to increased workloads and interest payments, and

     -- the cutback of $6 billion, of which $1.5 billion is a reduction in lending and other financial adjustments.

   . This yields current estimates of

     -- $183.7 billion for total Federal outlays, compared with $186.1 billion in January;

     -- $184.1 billion on the national income accounts basis, down from $185.0 billion in January.

2. Based on the economic outlook described below, revenues for FY 1969 are estimated at

     -- $178.6 billion for the unified budget, leaving a deficit of $5.1 billion; and

     -- $182.3 billion on the national income accounts basis, leaving a deficit of $1.8 billion.

3. In our May Troika memo, we said that the tax surcharge and expenditure cuts would cool off the economy, move unemployment higher, and involve risks of excessive fiscal restraint. (We stressed that failure to take fiscal action would have involved even greater risks.) The economic outlook now points to an even slower growth pattern than we expected then.

- The main reason we expect slower growth now than we did in May is that Federal purchases have been running higher than we anticipated. This means that in order to accomplish the required cuts, the decline in purchases during the course of the fiscal year will have to be larger than was assumed in the May forecast.

  Real growth of GNP is now projected at a little more than 1% (annual rate) from the second to the fourth quarters of 1968. Then, real GNP is essentially flat -- no growth at all -- in the first half of next year.

- Unemployment would rise slowly in the next few months, reaching 4% in the fourth quarter. Then it would be expected to rise considerably, further early in 1969, to between 4-1/2% and 5% in the second quarter.

- Inflation should slow down gradually to about a 2-1/2% annual rate by mid-1969.

4. The tax bill is the medicine we need to slow down and curb inflation. But the expected slowdown in early 1969 is more than we would like.

- The rise in the unemployment rate to a range of between 4-1/2% and 5% would mean

  -- only a little more benefit on the inflation front than would be accomplished by an unemployment rate of 4-1/4%;

  -- substantially higher unemployment rates for Negroes and teenagers.

- In some ways, the economy in the first half of 1969 would resemble the pause of the first half of 1967. At that time, recession became a worrisome threat but not a reality.

5. There are substantial uncertainties in the forecast. Our staff has tried to make the best judgments it can.

   - As the economy slows, the saving rate is expected to fall markedly. It could go down even more or not decline as much as projected. A further decline in the saving rate would help to buoy the economy.

   - The projections of spending on plant, equipment, and inventories allow for adjustments by business firms to the slowdown. But they assume that business confidence about the longer term outlook will not deteriorate.

   - Homebuilding is projected to pick up strongly beginning in the fourth quarter. Indeed, it is the key factor preventing an outright recession in the first half of 1969. We are reasonably confident that the demand for new homes would support this strong performance. But we can't be sure that mortgage credit will be available in adequate supply unless monetary policy moves appropriately.

6. The projected rise in housing will require a vigorous expansion of credit in the coming months.

   - Net inflows of funds into savings and loan associations in the first half of 1968 were 20% below the last half of 1967. A substantial increase will be required to support the level of housing in the projection.

   - There have been encouraging recent declines in interest rates. In part, these seem to reflect market expectations of further easing action by the Federal Reserve.

   - But these recent declines will have to be followed by further reductions in interest rates in the coming months in order to achieve the housing estimates in the forecast.

• In short, the forecast assumes a continuing trend toward monetary ease. Otherwise, there would be far more danger that the uncomfortable pause in growth could turn into a disturbing recession.

Joseph W. Barr

Joseph W. Barr
Acting Secretary of the Treasury

Arthur M. Okun

Arthur M. Okun, Chairman
Council of Economic Advisers

Charles J. Zwick

Charles J. Zwick, Director
Bureau of the Budget