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THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

EYES ONLY

May 6, 1978

Spring
Budget Preview

MEMORANDUM FOR THE PRESIDENT

FROM: Charlie Schultze CLS

SUBJECT: Some disturbing thoughts about the economic outlook

Several recent and prospective developments pose some major difficulties for our economic objectives and policies. In the process of developing outlook material for your May 16 Budget Preview session, we have become increasingly concerned about these developments. This note provides an initial summary of the problem.

1. Greater than expected fall in unemployment. Taking the 1st and 2nd quarter together, the GNP is not far from the track we had been forecasting. But employment has grown very strongly and unemployment has fallen by almost 1 percentage point faster than past relationships with GNP would have led us to expect. A small part of this may be due to a greater than anticipated effectiveness of public service employment. But -- assuming our GNP statistics are basically correct -- most of it represents a very low growth in productivity. This low growth may be an aberration, or it may reflect a long-term loss in productivity. If it is the latter - so that the new relationship between GNP and employment is not reversed -- two problems will face us in the immediate future:

   o the lower productivity growth will give us larger price increases, since there would be less productivity to offset wage increases; and

   o unemployment, by late 1979, might fall to the range of 5.3 to 5.5 percent -- given the GNP growth we now forecast; this, in turn, could lead to labor market conditions in which wage rates might well be accelerating.

2. A monetary crunch. Economic growth in the current quarter is very large -- in the range of 8 to 10 percent annual rate. This is combined with very large food price increases. The combined growth in output and

prices is, in turn, leading to a very high growth of the money supply ($M_1$1), above the Fed's target range. The Fed has already raised interest rates by 1/2 percent in the past two weeks. Even if Bill Miller would be willing to live with monetary growth rates above target for awhile, the other members of the Federal Open Market Committee are not likely to -- especially when large growth in M_1 is combined with a strong second quarter and bad news on the inflation front. It is entirely possible that we could see a further sharp runup in interest rates over the next three months. After some time lag, such a development would begin to reduce housing construction, possibly by a sizeable amount in late 1978 and early 1979. In this eventuality, economic growth would slow sharply, leading to a significant rise in unemployment. While this would dispose of the problem discussed in (1) above, it would do so in a way we surely don't want.

3. Wage rate increases. Average straight-time earnings in April 1978 were 8.3 percent above a year earlier. In early 1977 earnings had risen only 7 percent above 1976. Some of this acceleration is due to the January increase in the minimum wage (which added perhaps 0.3 to 0.5 percent to the recent year-over-year gains). Some of the acceleration may be due to the direct and indirect effects of the speed up in food price increases. And, since labor markets have been improving rapidly in the last year, some of it probably reflects a catching up of unorganized and small union workers with the recent sizeable wage gains won by large unions. Once the rate of food price increases subsides the wage growth may fall back somewhat. But it is likely to continue at a higher level than last year and, indeed, the catch-up phenomenon might push the increases up again.

I have discussed the monetary situation with Bill Miller. Mike Blumenthal, Bo Cutter, (for Jim) Bert Carp (for Stu) Lyle Gramley, Bill Nordhaus and I met about the implications of these developments on Saturday morning. We are meeting again on Monday. We are considering strategies to reduce the FY 1979 and 1980 budget deficits, and we will probably be seeking an appointment with you this week to discuss the situation.

a new
Concert?

This memo is one of very few that discuss monetary growth.

Schultze believes that ~~high~~ fast output growth and rapid price increases lead to fast M1 growth.

His only apparent interest in money growth is that excessive M1 growth might lead the Fed to raise interest rates.

Note also that unemployment falling faster than expected is considered a bad thing. Indicates attachment to old Phillips curve, possibly.

THE WHITE HOUSE
WASHINGTON

May 8, 1978

cc LG
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LOGGED

Charlie Schultze

Date 5/8

The attached was returned in the President's outbox. It is forwarded to you for appropriate handling.

Routing
CLS/
PV

Rick Hutcheson

DISTURBING THOUGHTS ABOUT THE ECONOMIC OUTLOOK

ADMINISTRATIVELY CONFIDENTIAL