Chron

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

June 27, 1978

MEMORANDUM FOR THE PRESIDENT

From: Charlie Schultze

Subject: Background for the Quadriad Meeting on June 28

As I indicated to you in my June 14 overview of recent economic developments, the disturbing inflation developments recently and the response of the Federal Reserve to them are causing concern that the economy could slow excessively later this year and in 1979. Some slowing appears to us to be both likely and desirable. But the coordination of monetary and fiscal policy can make a critical difference between desirable moderation and slowing down at least to the point of a "growth recession."

CEA and Mike Blumenthal met with the Federal Reserve Board on June 19 to discuss these matters and to assess their views. The impressions we gleaned are the following:

- The Board is very concerned about inflation;
- Some members of the Board appear to be prepared to tighten monetary conditions still further;
- With perhaps one exception, the members of the Board do not see even a growth recession as desirable to combat inflation. But they seem willing to run some risks with tight money because of their inflation worries.
- Chairman Miller is under considerable pressure from some of the more vocal and articulate inflation-fighters on the Board. He, himself, is very sensitive to the danger of overdoing monetary restraint.

Attached is a proposed agenda for the Quadriad meeting. I have not had the opportunity to discuss this with Chairman Miller because he has been out of town. In light of the

June 19 meeting, however, he probably anticipates something along the lines I am proposing. The following material provides some background on these points.

A. The Outlook for the Next 18 Months

As I reported to you earlier and as we discussed with the Board, our forecast calls for growth of real GNP at a rate of 3-3/4 to 4 percent from the middle of this year through the end of 1979.

- A substantial slowing in the second half of this year from the 7 percent annual rate of increase between the first and second quarters (according to the first, unpublished Commerce estimate) seems already to be indicated. In May, employment, industrial production, personal income, retail sales and housing starts all indicated a slowing from the March-April catch-up pace.

- The exceptionally slow growth of productivity recently (only 1 percent over the past year in contrast with a "normal" trend closer to 2 percent) makes it very difficult to forecast the movement of unemployment that would be associated with our GNP forecast. Our best guess is that the unemployment rate will change little over the remainder of this year -- as productivity growth catches up partially -- and that it will decline slightly next year.

- Since the unemployment rate has dropped substantially over the past year and some labor markets may have tightened to the point of exerting upward pressure on wages, this outlook seems an appropriate target for the immediate future in order to avoid aggravating the inflation problem.

A number of private (and foreign official) forecasters are pointing to substantial uncertainties in the outlook. There are a few extremists on Wall Street who see interest rates skyrocketing and a real recession set in motion by year end or early 1979. But this is not the prevailing view. The concerns that do seem to prevail center around the following sequence of developments:

- Inflation has accelerated; even if food prices stop rising as fast as this spring, the higher price levels threaten to boost wage increases in the near future.

- The Fed will respond to these inflationary pressures by some further increases in interest rates.

- Higher interest rates, the substantial growth in consumer and mortgage debt burdens that households have already incurred, and the erosion of real growth in personal income due to higher food and import prices will lead, collectively, to a noticeable slowing in consumer purchases of durable goods and a reduction in residential construction.

- Slowing growth of final sales and the higher cost of funds will cause fairly slack growth of business fixed investment.

- Although these developments probably will not be severe enough to cause real GNP to decline, growth will be slow enough to let the unemployment rate rise and to make the threat of a GNP downturn much more significant.

This sequence of events cannot be forecasted with any certainty; reasonable questions can be posed about many links in the chain. There is enough precedent in the postwar period, however, for this pattern of developments that the possibility cannot be dismissed.

B. The Battle Against Inflation

Inflation is the key cause of malaise at the Fed as well as elsewhere. This spring we have had the dual problems of inherited momentum from past inflation plus the run-up in food prices. Measures to control oil imports, and the energy program generally, may add another blip to inflation later in the year but this cost will be offset by the benefits in reduced oil imports and lessened pressure on the dollar.

After excluding food and mortgage interest costs, the rate of increase in consumer prices this year has been in the 6 to 6-1/2 percent range. The rate of increase in average hourly earnings has tended to creep up, however, so the rise in unit labor costs (a key determinant of the underlying rate of inflation) during the coming year may be closer to 7 percent.

1. Food prices -- the worst may soon be over. Following an increase of 7 to 7-1/4 percent (not annual rate) in food prices during the first half of the year, we are now forecasting an increase of 1 to 2 percent in the second half of the year. There are signs of meat and some vegetable prices coming down.

2. Labor settlements -- although only about 25 percent of the work force is unionized, union contract settlements have high visibility and their costs tend to pass through quickly into prices. Thus far, the deceleration program has not had any visible successes with organized labor. As you know, the two key settlements this year, which will set the tone for next year's major bargaining round, are the Railroad Workers and Postal Workers.

3. The deceleration program -- some successes have been achieved in obtaining commitments from business to decelerate the rate of increase in their prices. Since late April, the three major automobile manufacturers, the three major aluminum producers, and General Electric, AT&T, W. R. Grace, among others, have indicated some degree of cooperation with your anti-inflation program. You may wish to indicate to Chairman Miller that if this momentum can be maintained and if some deceleration of prices actually becomes observable, it will help considerably in obtaining cooperation from labor. However, he can be expected to point out that success on the price front cannot be extended indefinitely without deceleration in wage costs.

C. The Appropriate Posture for Monetary and Fiscal Policy

As noted above, we believe that our forecast of 3-3/4 to 4 percent real growth over the next year and a half is both a reasonable forecast and an appropriate target for policy. This forecast is based on the following policy assumptions:

- no further increase in most interest rates. Since the beginning of the second quarter -- when inflation and the spurt in real growth boosted the growth of the monetary aggregates sharply (see attached charts) -- the Fed's target rate of Federal funds has been raised a full percentage point (from 6-3/4 to 7-3/4). The latest 1/4 point increase occurred in the middle of last week, following last Tuesday's FOMC meeting. Other short-term market interest rates adjust with varying speeds to the Federal funds rate but normal adjustments to the current target will bring these market rates to the levels we have assumed to prevail during the forecast period. The prime rate at commercial banks had already risen by another 1/4 point at the end of last week, to 8-3/4 percent, and it may rise further.

- growth in M_1 above the Fed's target range (4-6-1/2 percent) and growth in M_2 near the top of the range. There is substantial uncertainty about what growth rate in the monetary aggregates will be consistent with our GNP, price and interest rate forecasts. The slowdown in real output growth in the second half of the year should substantially reduce pressure on the growth of the aggregates and it is possible that growth in M_2 (the broader measure) may remain quite close to the top of the current target range.

- a $20 billion tax cut effective next January 1.

- unified budget expenditures of $450 billion in FY 1978 and about $495 for FY 1979. This is consistent with the spring budget review and implies no further shortfall.

Can interest rates rise above our forecast without significant effects on real growth, particularly in the housing and business investment sectors? We think there would be serious risks involved in further significant interest rate increases. No one can say with certainty because institutions change and the current inflation rate makes historically high interest rates both inevitable and less restrictive. Nevertheless, the increase in interest rates over the past two years is relatively large in comparison with corresponding periods since the mid-1950s (excluding the 1972-74 period which is distorted by the tremendous acceleration of inflation then). Continuation of sharp increases would raise serious questions concerning the capacity of the economy to adapt. The possibilities of sharp cutbacks in residential construction and eroding growth in business fixed investment are real. Some forecasts would suggest that a further increase of 1 to 2 percentage points in interest rates by early 1979 could raise the unemployment rate at the end of 1979 to 6-1/2 to 7 percent.

The gains on the inflation front from such a slowdown in real growth -- induced by interest rate increases -- would be visible but small. The rate of inflation, measured by the GNP deflator, might be slowed by at most one-half percentage point in 1979.

You may wish to explore with Chairman Miller his perceptions of these uncertainties and the limitations that they may impose on the course of monetary policy in the coming months.

Attachments

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

June 26, 1978

Proposed Agenda for the Quadriad Meeting, June 28, 1978

1. Assessment of the outlook for real growth in the next year

1. Assessment of the outlook for real growth in the next year to eighteen months:

   o What is the appropriate growth target for fiscal and monetary policy over the next year to eighteen months; does Chairman Miller agree that the 3-3/4 to 4 percent range, which we are now forecasting, is about right as a target -- as a forecast?

   o Discuss the emerging concern among some private forecasters that economic growth may slow too sharply in the next year; the reasons for the concern are principally rising interest rates and inflation.

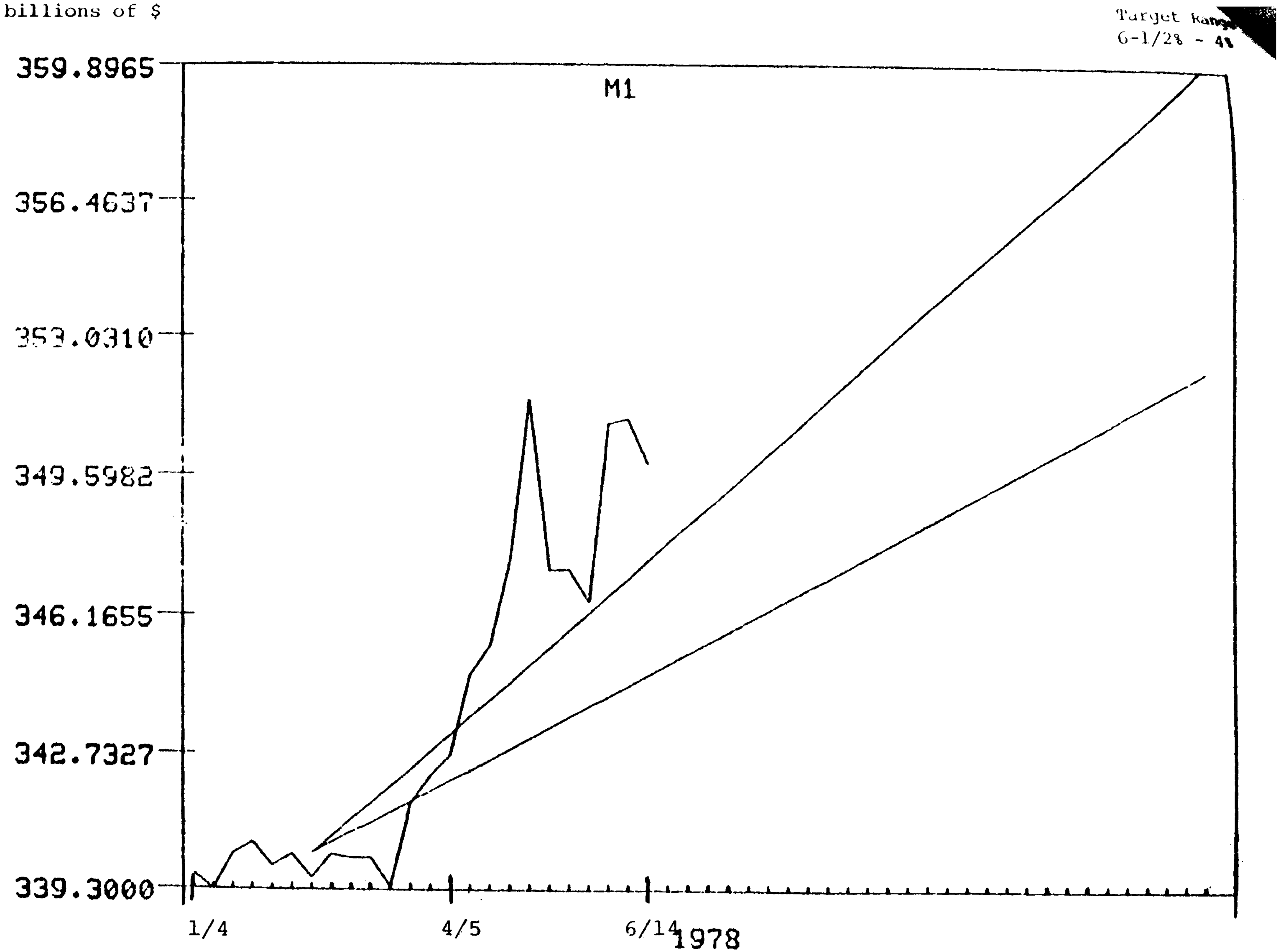
2. Review of the battle against inflation -- prospects, problems, successes. This might include a review of

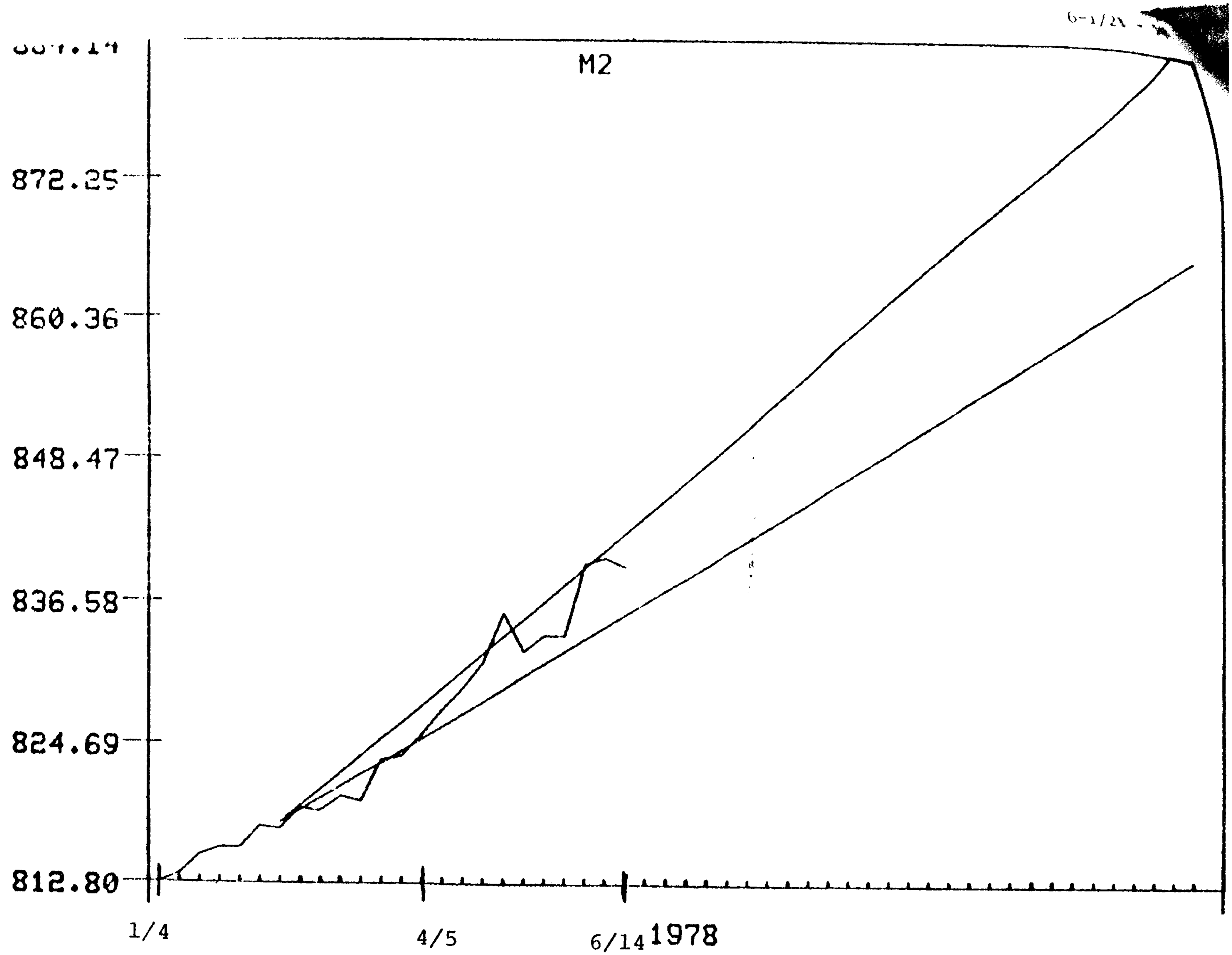
   o the outlook for food prices,
   o labor settlements,
   o the deceleration program.

3. Assessment of the appropriate posture for monetary-fiscal policy. This might focus on two areas:

   o How much further can interest rates rise without threatening to stall overall growth and jeopardizing prospects for housing and business investment? On the other hand, how much further increase in interest rates is appropriate to contain inflation? Are there conflicts between these objectives and how might they be resolved?

   o What problems would arise if the Congressional impasse on the tax cut persists through the end of the Term? How could this be dealt with?


billions of $
Target Range
6-1/2% - 4%
M1
359.8965
356.4637
353.0310
349.5982
346.1655
342.7327
339.3000
1/4
4/5
6/14
1978



M2
872.25
860.36
848.47
836.58
824.69
812.80
1/4
4/5
6/14
1978

Cbron

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

June 26, 1978

Proposed Agenda for the Quadriad Meeting, June 28, 1978

1. Assessment of the outlook for real growth in the next year to eighteen months:

   o What is the appropriate <u>growth target</u> for fiscal and monetary policy over the next year to eighteen months; does Chairman Miller agree that the 3-3/4 to 4 percent range, which we are now forecasting, is about right as a target -- as a forecast?

   o Discuss the emerging concern among some private forecasters that economic growth may slow too sharply in the next year; the reasons for the concern are principally rising interest rates and inflation.

2. Review of the battle against inflation -- prospects, problems, successes. This might include a review of

   o the outlook for food prices,
   o labor settlements,
   o the deceleration program.

3. Assessment of the appropriate posture for monetary-fiscal policy. This might focus on two areas:

   o How much further can interest rates rise without threatening to stall overall growth and jeopardizing prospects for housing and business investment? On the other hand, how much further increase in interest rates is appropriate to contain inflation? Are there conflicts between these objectives and how might they be resolved?

   o What problems would arise if the Congressional impasse on the tax cut persists through the end of the Term? How could this be dealt with?