THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

EYES ONLY

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MEMORANDUM FOR THE ECONOMIC POLICY GROUP

From: Charlie Schultze

Attached is a draft of a paper on overall economic policy measures to deal with the current inflation situation. It does not cover other elements of policy -- food, price monitoring, etc. It has only a short analysis of consumer credit controls. We should have a more detailed Fed-CEA analysis by tomorrow.

Attachment

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I. Economic Background

Since our economic policy for 1979 and 1980 was formulated late last year, a number of developments have occurred that immediately threaten the success of the anti-inflation program and increase the chances of a recession later on.

1. Inflation rates. While we expected high inflation to continue in the first part of 1979, before the anti-inflation program had time to bite, price increases in the last several months have actually accelerated:

- From November to January the CPI rose at a 9-1/2 percent rate compared to our internal forecast of about 8 percent. Had the fall in property tax rates in California not moderated the rise in the December index, the November to January rate of increase would have been 10-1/2 percent.

- Although food prices played a large role in the acceleration, nonfood prices in the CPI rose at an annual rate of almost 9 percent (corrected for the California property taxes, 10 percent). The February CPI, when released later this month, will almost surely show another large gain.

- The annual rate of increase in producer prices for finished goods, except food, was 11-1/2 percent from November to February.

- OPEC scheduled a 14-1/2 percent price rise during 1979, compared to the 8 to 9 percent we had expected. The Iranian crisis is likely to raise that figure substantially. Internationally traded raw materials prices have also been increasing sharply.

Although price increases have been accelerating, wage increases have not. CWPS has examined some 20 union contracts negotiated since October. Only two of them seem to have been above the pay standards. According to most reports, nonunion pay increases have been kept within bounds. Average wage increases for the economy as a whole have been moderate in the past three to six months, after adjusting for the minimum wage increase in January.

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Some of the price inflation may have resulted from "front-loading" of increases under the price standard. Many small- and medium-size firms are probably not complying with the price standard. But some of the acceleration in prices undoubtedly resulted from the unexpected strength in the economy discussed below.

2. Economic growth. The GNP rose at a 6-1/2 percent rate in the fourth quarter, and most indicators point to continued surprising strength since the turn of the year. Consumer spending, which rose phenomenally in the last three months of 1978, has eased somewhat in January and February from the December peak level.

The burst of consumer spending in late 1978 reduced inventories below desired levels, and there is every evidence that business firms are increasing production to replace them. Production and orders for investment goods have been rising very sharply.

- Total employment rose by 800,000 persons between December and February.
- New orders for durable goods rose 11 percent in the fourth quarter of 1978 and another 5 percent in January (not annual rates).
- Orders for business investment goods rose 13 percent in the fourth quarter and another 4-1/2 percent in January.
- Total hours worked in durable goods manufacturing rose at an annual rate of 12 percent in the past six months; total hours worked in the nonelectrical machinery industry rose by 16 percent over the same period.

Until recently the main thrust of economic growth was led by housing and the consumer. That situation is now changing. Housing is now in the process of turning down, and the pace of consumer spending has slowed, at least temporarily. But there is every indication that business firms are now scrambling to replace and add to inventories and to order new capital goods. A private survey, conducted monthly, shows a very large rise in the percentage of companies reporting slower deliveries during recent months. This is a sign of increasing

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supply tightness. CEA has conducted an informal telephone survey of businessmen and economists in a wide range of industries. With some exceptions, those contacted report rapidly swelling order books and a sense -- which had not existed earlier -- of speculative inventory buying to beat potential shortages (and, possibly, further price hikes). In the industrial sector of the economy there is clearly a boom underway -- perhaps very temporary, but nevertheless real.

3. Monetary conditions. Paradoxically, while economic growth speeded up during recent months, the growth of the monetary aggregates slowed down. In the past three months M_1 fell at an annual rate of 2.3 percent and M_2 rose at an annual rate of only 1.3 percent.

We believe that the behavior of the monetary aggregates does not signal a coming decline in economic activity nor does it reflect an extremely tight monetary policy.

- The combination of higher interest rates and new forms of highly liquid financial instruments have led people to economize on their use of cash. As a consequence, the economy has been able to grow rapidly without the injection of large new supplies of money from the Fed.

- Business profits have soared in recent months. Firms have been able to moderate their demands for credit.

- Banks are highly liquid. Business credit has been available without significant increases in interest rates during the last several months.

- Since inflation expectations have worsened, the same nominal interest rates appear more attractive to borrowers, who count on continued high inflation to ease their future debt burden.

The interest rate increases which occurred in 1978 are clearly not deterring spending to anything like the extent they did in earlier periods. Had the monetary aggregates in recent months grown in a "normal" relationship to the expansion in output and prices, the Fed would almost surely have been tightening monetary policy further. The abnormally low growth of the aggregates has led to a monetary

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policy that is exerting only modest restraint on a surging economy. While the 1980 budget will put more restraint on the economy, that restraint won't show up for another nine months.

In summary, we think that the economy is currently expanding at too rapid a pace. Some of the recent acceleration in inflation is almost surely due to this fact. We are in danger of of a speculative bubble developing. Anticipations of future price increases have already been affecting consumer purchases of housing and household durables. We have no solid evidence that business firms are ordering to beat price increases, but the dangers of inventory speculation are very real. If that happens we could see a further increase of inflationary pressure in the short run. At the same time distortions could develop that would greatly increase the likelihood of a recession later on -- beginning either late this year or in early 1980. Most outside forecasters have been predicting a recession in late 1979. But virtually all of them predict a mild recession. Should speculative distortions develop early this year, the danger of a more serious recession would mount.

II. Options for Achieving Greater Restraint: Risks and Gains

There are three general courses of action that could, in principal, be used to achieve additional restraint on aggregate demand: 1) a tightening of fiscal policy; 2) special measures to dampen housing or consumer spending; 3) additional monetary restraint applied generally through one or more of the conventional tools of monetary policy. Each of these options is discussed in turn.

Fiscal Policy

Added fiscal restraint in 1979 would be desirable if it could be readily and quickly achieved. A tax increase is clearly out of the question; any additional restraint will have to come from the expenditure side. From a psychological standpoint, it would be very desirable to include at least a small step on the budgetary front in any package of measures to cool off inflation. But there are serious practical difficulties in doing so.

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OMB has looked at several possible methods for holding down the rise of outlays in fiscal 1979. The most practical course would appear to be an across-the-board percentage reduction in outlays from new budget authority applied to all programs except entitlement or other fixed-cost or open-ended programs and possibly also defense. The Congress is presently considering a third 1979 Resolution to raise the outlay ceiling by $5 to $7 billion over the $487.5 billion in the second Resolution. An across-the-board cut in outlays from new authority (except for entitlement programs) might hold down the increase to, say, $2-1/2 to $3 billion, so that outlays would come in around $491 to $492 billion -- slightly below the Administration's recommended level. The difficulties with this course of action, however, are many:

- The amount of reduction in budget authority necessary to achieve any given percentage reduction in total outlays from new authority would have to vary from one program to another. There would be an appearance of unevenness of treatment that would be hard to explain.

- There would likely be great difficulties in getting Congress to go along with such a request. Among other things, the requirements of the Impoundment Control Act would have to be waived to permit the cutback in outlays, and this is a sensitive issue.

- The effects on programs would differ from one agency to another. Agencies whose funds have already been heavily obligated would have greater difficulty. The legislative authority would have to specify exemptions for agencies whose funds are so heavily obligated as to make it impossible to meet the percentage reduction.

- The actual effects on aggregate demand likely to be achievable before late this year are small.

- The effects of such an approach are bound to carry over to some degree into spending levels in fiscal 1980.

- The Administration would be in a politically embarrassing position asking for cuts in FY '79 outlays from new authority soon after sending to the Congress a series of supplemental appropriation requests, including a $2-1/2 billion supplemental for defense.

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- o If defense were excluded, achieving meaningful restraint would require deeper cuts in other programs, with correspondingly larger disruptive effects in individual agency budgets and greater adverse political reaction.

The problems likely to be encountered in going this route can hardly be overestimated. Added fiscal restraint does not, therefore, seem achievable either readily or quickly.

Special Measures to Dampen Housing or Consumer Spending

Special devices to curtail housing or to dampen the rise of consumer spending, especially for durable goods, are not a perfect substitute for more general measures of restraint on aggregate demand. In particular, such measures would not directly reduce business demands for inventories, which are now threatening to add a speculative element to demands for goods and services. The economic wisdom of using such devices under present circumstances is questionable for other reasons. There may be strong psychological and political attractiveness, however, in a moderate program to restrain consumer credit.

Housing

Prospective supplies of mortgage credit have already been curtailed by actions of the regulatory authorities to limit the ability of commercial banks and thrift institutions, especially the latter, to bid for 6-month money market certificates. Further steps might take the form of encouraging the Federal Home Loan Board to limit advances from Federal Home Loan Banks to member associations, or asking FNMA to reduce its forward commitments to buy mortgages.

Further steps to concentrate the effect of restraining actions heavily on the housing industry are not attractive. Some decline in housing is probably already underway, although the extent of decline -- given policy actions to date -- is uncertain. Such steps might not, in any event, obviate the need for more general measures of monetary restraint to help cool off business inventory investment; if the Fed took action to raise interest rates generally after steps were taken by the Administration to reduce selectively the availability of mortgage credit, we could easily find that housing starts declined more than we want this year.

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Consumer Credit Controls

Using the authority of the Credit Control Act of 1969, the President could request the Federal Reserve Board to impose controls on consumer credit. The specific authority open to the President under this act is presently being reviewed by the Justice Department; a study of the practical feasibility and the economic effects of doing so is also being conducted, headed by the CEA. The results of that study should be available within a day or so. The following is a brief synopsis of the major economic considerations.

Controls over consumer credit would be most appropriate if it were thought that consumers would continue to incur debt aggressively in 1979, so that consumer spending would continue to rise about as rapidly as the disposable income. The current interagency forecast (which is nearing completion) does not contemplate that; instead, the forecasting group expects a rise of nearly three-fourths of a percentage point in the saving rate, and a decline in real purchases of durable goods by consumers after the first quarter. Current data on consumer spending neither confirm nor negate this expectation: retail sales in January and February are down somewhat in real terms from a very high December level, and auto sales have remained at about the level of the fourth quarter. Consumer installment credit growth turned up in the fourth quarter but has declined significantly in January. Putting the brakes on consumer borrowing now may be closing the barn door after the horse got out, but we cannot be sure.

The study of economic effects and practical feasibility, while not yet completed, suggests the following points:

- For auto loans, minimum downpayment requirements could be easily evaded; maximum maturities would be easier to enforce. Administrative costs would likely be high. The impact on auto sales of reducing maximum maturities to, say, 42 months would be highly uncertain, but possibly large in the short run. Going this direction would clearly reduce our chances of getting a UAW settlement in compliance with the pay standard.

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- For revolving credit (charge cards), the simplest device would be to increase the minimum monthly percentage repayment.

  -- The effects on consumer debt repayments could be most readily controlled if the higher percentage repayment were applied retroactively to all loans now outstanding. This may or may not be legal. (We are getting a Justice Department opinion.)

  -- If applied prospectively to new loans, the magnitude of purchasing power drained off into debt repayment would increase over time to levels that are larger than desirable. Any scheme that would have a significant impact in the short run, would grow into an excessive impact later on. Prospective application might also pose a significant administrative problem for lenders. (The repayment schedule on currently outstanding debt would have to be calculated at one rate and the schedule on new debt at another.)

- Any use of consumer credit controls has to recognize that those who are hit the most are lower-middle income groups and individuals who are financially unsophisticated.

- Invoking the authority of the Credit Control Act of 1969 in one area may lead to expectations of its use in others, and hence to a scramble for credit.

General Measures of Monetary Restraint

Increased general monetary restraint could be effected by any one of several steps by the Federal Reserve: open-market policy, an increase in the discount rate, or an increase in reserve requirements generally or on particular market instruments (CD's, REPO's, etc.). As long as the rise in short-term market interest rates is the same, any or all of these steps would achieve broadly similar economic results.

An increase of, say, one-half percentage point in short-term market rates of interest would have its principal effect on housing. Curtailment of mortgage credit availability might also spill over into consumer spending as well, since turnovers of existing houses and second mortgages typically lead to a withdrawal of equity from the housing market for use in consumer expenditures.

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In the business sector, a rise in short-term interest rates may also help to dampen business purchases for inventory that are being stimulated, in part, by expectations of price increases and/or shortages. A higher cost of inventory financing would contribute directly to this result; expectations that monetary restraint would cool off the economy would make an indirect contribution to this end. To achieve these expectational results, it would be desirable to use monetary weapons (such as the discount rate or reserve requirements) that tend to be regarded as strong signals of the intent of the monetary authorities.

There would be some dampening effect of increased monetary restraint on business fixed investment as well, but this effect is likely to be small for two reasons. First, the volume of business fixed investment this year is likely to be limited principally by restraints on capacity in the capital goods industries -- particularly aircraft, railroad rolling stock, and nonelectrical machinery. Second, a rise in short-term interest rates would be likely to increase the cost of long-term credit relatively little, since participants in financial markets are still generally expecting a downturn in interest rates later this year.

Econometric models suggest that an increase of 50 basis points in short-term interest rates would reduce real GNP over four quarters by approximately 0.3 to 0.4 percent, and add about one-tenth to the unemployment rate. The current interagency forecast, which assumes a further 50 basis point increase in short-term rates, is for a rise of real GNP of 2.1 percent over the four quarters of 1979 -- or close to the January forecast. Somewhat weaker growth in personal consumption expenditures (due to a squeeze on real wages) and in housing (because of higher interest rates) is largely offset by higher business investment in both fixed capital and inventories. (The forecast also assumes a $16.00 price for OPEC oil by fourth quarter 1979.)

The outlook for 1980, as the group now sees it, is for a rise of about 2-3/4 percent in real GNP, about half a percent less than expected in January. There are clearly still risks that the economy will be weaker next year than we now forecast. The principal risks in that regard are: (1) that the anti-inflation program may break down because strong price pressures lead to an unwillingness of workers to continue to accept 7 percent pay increases; and (2) that inventory speculation in 1979 may lead to imbalances that seriously weaken the economy.

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The strongest arguing points for additional monetary restraint are to reduce the prospects that business will abandon the conservative inventory policies that have characterized the recovery to date, and to indicate the Administration's firm determination to make the anti-inflation program work. There are, of course, risks in going in this direction. Inventory policy may not respond as we hope it will. The degree of strength we will see in personal consumption expenditures and housing later this year is uncertain; if developments in these sectors turn out weaker than we anticipate, added monetary restraint now could result in a slower economy than we anticipate. While the momentum of business capital investment appears great enough to ward off the threat of a recession later this year and in early 1980, we cannot be sure.

On balance, the risks of taking firm actions now with general monetary instruments appear greater than the risks of doing nothing. The latter course risks the development of speculation in inventories and additions to price pressures that may deal a death blow to the anti-inflation program. If distortions and imbalances develop as a consequence, a recession will be difficult to avoid. If, on the other hand, the economy late this year proves to be weaker than we now expect, a return to less monetary restraint would be possible. It is easier to take steps to stimulate a moderately weak economy than it is to rescue one that is about to head into recession.

Finally, if we fail to try to damp down the current surge, and inflation is fed by speculative excesses over the next four to six months, we will have built in an even higher underlying rate of inflation which no feasible policy can get rid of. In trying to slow the economy now, we might indeed contribute to an excessive slowdown later on. But it is far easier and quicker to reverse such a slowdown when it occurs than it is to wring out a new increment of inflation, once it has gained momentum.

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