Inflation and the Economic Outlook*

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This morning I would like to spend some time with you reviewing the current economic situation and the outlook for the coming year. As you know, it is a subject that has been receiving considerable attention these days. A good way to start is to look at some of the significant developments of the past year and their implications for the new year.

The year 1973 was memorable for the economy, for many reasons. It started out with the termination of the Phase Two controls in January, quickly followed by an international currency crisis and the second devaluation of the dollar in February. And the year ended in December with the economy—and the world in general—still dazed by the effects of the oil embargo, but finally attempting to come to grips with the underlying problem of energy shortages. It was also a year that saw the Dow Jones average slide by over 150 points between January and December.

Looking back at the year as a whole, however, perhaps its most important characteristic—and one whose importance was not as well recognized as it might have been—is that 1973 was a boom year, a year of exploding prices, a year of burgeoning inflation, and a year marked by enormous pressures on productive facilities.

Real output rose extraordinarily over much of 1972 and through the first quarter of 1973, measured in terms of both real gross national product (GNP) and industrial production. As a result, the economy suffered severe capacity constraints beginning early last year—a development that many economists, statisticians, and policy makers were slow to recognize. The conventional view in late 1972 was that, because the overall unemployment rate remained significantly over 4 percent, output limits were still quite distant. In retrospect, this was a misjudgment, and in some respects it may have encouraged overly expansive monetary and fiscal policies in 1972. By early 1973, the serious pressures we still see today had already been developing.

These pressures show clearly in the economic barometers. Capacity utilization of major materials-producing industries was at record levels. This factor—the nearly complete utilization of capacity—and not tightness in the labor markets—was the most conspicuous bottleneck in the economy during the year.

Labor markets were, of course, fairly tight during most of 1973, with the unemployment rate dropping to 4.6 percent in October. That figure may not seem to indicate substantial tightness compared with historical figures—such as the low of about 3.5 percent in the late 1960's. However, the overall rate doesn't provide the best historical measure because of the rising proportion of young people and women in the labor force, two groups with above-average unemployment rates. In any case, while the labor markets were relatively tight last year, they have been as tight or tighter before, and they do not seem to have been the primary cause of supply constraints during the year.

In retrospect, it seems clear that it was primarily the strain on capacity worldwide, compounded by a number of other factors (such as grain and protein shortfalls), which resulted in a rather distressing price performance for the year—and despite the continued existence of a price control program. The situation was aggravated by additional pressures that resulted from the abrupt spurting of prices as soon as Phase Two was terminated, the devaluation of the dollar, the reemergence of excess demand, and the further rounds of price increases in anticipation of the reimposition of stricter controls.

As you will recall, the price explosion that took place

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at the beginning of Phase Three subsequently led to the two-month price freeze starting June 13, and then the establishment of the Phase Four controls in mid-August. Phase Four is still with us, although controls have been lifted from many industries. It may be too soon to pass final judgment on Phase Four, but no one can be very enthusiastic about it. Since June, consumer price increases have actually accelerated, even compared with Phase Three. In any case, the Administration is willing to allow statutory authority for controls to lapse at the end of April, except for fuel and health care.

Consumer prices haven't yet fully reflected the advances in wholesale industrial prices. We don't know what the ultimate effects will be, but in any case we can't be too optimistic about the future.

Looking back with the benefit of hindsight at the overall control program, while Phase Two looked successful, it is now clear to most observers that subsequent developments had distorting, disincentive effects in many cases, encouraging exports and discouraging production for the domestic market precisely in those areas where shortages have been worst. Perhaps just as important is the fact that this performance has generated a widespread disillusionment with controls on the part of both business and labor.

Some cautious optimism on the price outlook for 1974 developed last fall as food prices dropped well off their August peaks. It did not seem likely that the 1973 price bulge would be repeated, since world demand pressures on commodity prices generally appeared to be abating. In addition, the worst of the post-freeze bunching of industrial price increases seemed likely to be completed early in 1974. But the energy shortage has darkened that prospect, and now fuel prices are vying with food prices as the chief villain in the inflation drama.

Nobody seems to be too sanguine about the prospects for prices in 1974. The range of recently published forecasts for 1974 prices is rather wide, reflecting deep uncertainties, but they all indicate continuing high levels of inflation. The Council of Economic Advisers forecast a 7 percent increase in the GNP price deflator in its annual report. Even the low end of the range of recent forecasts is a relatively high figure of about 5 percent, and even that is wishful thinking—although it's not impossible that improvement by the second half might materialize.

Turning to forecasts of GNP, current statistics show a definite slowing in the economy that, so far, seems consistent with the consensus forecast of a slowdown in real GNP. However, it is difficult to be sure how far the trend will carry.

Growth in industrial production and real output slowed sharply in the fourth quarter. Industrial production actually declined in December, January, and February largely as a result of energy cutbacks and slowing production in the auto industry, which has its special, and partly energy-related, problems.

The unemployment figures have also reflected some slowing in the economy, in good part because of the energy situation. The rate rose from a low of 4.6 percent in October to 5.2 percent in January and then remained at that level in February. At this point, it would appear that, with the present labor market structure and composition, unemployment rates of under 5 percent can't be sustained for very long without accelerating inflation rates. Nevertheless, unemployment rates could well rise this year—at least for a time—to undesirable levels.

Turning to the outlook for demand, we see areas of both weakness and strength. Housing has been for some time the primary example of weakness. Housing starts declined over much of 1973 to levels that were low in relation to long-term trends. With an improved flow of funds into thrift institutions, however, most analysts have been assuming that an upturn would develop by mid-year. Indeed, starts rose in both January and February, but it would probably be premature to conclude that a sustained upturn has already begun.

The second most obvious area of demand weakness has been cars. Of course, an easing of the gas shortage and the completion of plans to shift output to smaller cars should begin to provide a lift. However, it should also be noted that, after adjusting for price increases, retail sales excluding autos have been essentially flat for many months.

On the optimistic side, one area of seemingly clear prospective strength is business capital spending. Various government and private surveys suggest a 12 to 18 percent rise in business capital spending this year, which isn't surprising given the capacity problems in many industries.

Another plus in the outlook is the low level of inventories relative to sales—with the conspicuous exception of standard-size cars. Indeed, shortages are probably holding stocks below desired levels in some fields. Thus, on balance, there are no signs of impending excess-inventory problems that have been associated with most postwar recessions.

As far as the Federal budget is concerned, the projected fiscal 1975 deficit is scheduled to rise moderately, mainly because a slower economy should cut tax receipts. However, it seems more pertinent that there is likely to be another large rise in outlays. On balance, we would characterize the 1975 budget as being like the current fiscal 1974 budget—moderately stimulative.

As for monetary policy, in retrospect it is now generally agreed that the growth of monetary aggregates in 1972 was somewhat excessive. The Federal Open Market Committee wasn't willing at that time to see money market conditions tighten up to the degree and with the speed necessary to ensure a slower growth rate. In 1973, however, a number of steps were taken to lower the growth of these aggregates to a more moderate rate. For example, marginal reserve requirements on large certificates of deposit (CDs) and related bank sources of funds were raised. The discount rate was advanced in six steps to the current all-time peak of 7.5 percent. Most important, open market operations were aimed at bringing the monetary aggregates under tighter control.

While everyone would agree that we went through a period of relatively tight money in 1973, there are various ways of assessing just how tight it was. M_1 (checking account balances and currency outside banks) averaged a moderate and appropriate 5.7 percent over 1973 as a whole. Within the year, however, the aggregates showed, as always, wide short-run fluctuations.

This may be a good point to note that the Federal Reserve's ability to control the growth rates of the money supply and bank credit over short periods is very limited. Moreover, short-run deviations—say, up to six months—from longer term objectives are probably not damaging to the economy, at least if they are subsequently offset. I'm afraid that there is a widespread tendency to try to overinterpret these short-run movements.

As for bank credit growth, it was quite rapid through much of 1973 partly because of the assignment of the Committee on Interest and Dividends, under the control program, to hold bank loan rates from rising as fast or as far as they might otherwise have. As a result, banks were an unusually cheap source of funds until open market rates, such as the commercial paper rate, began falling in September. Thus, more lending moved through the banking system earlier in the year than would have been normal for a tight-money period. Banks financed the loan expansion by issuing CDs, a technique that was enhanced by the absence of Regulation Q ceiling restraints.

Slowing the money supply growth rate during 1973 in the face of a strongly advancing economy involved some very sharp short-term rate advances to historical peaks by late summer. Indeed, the behavior of short rates is the only measure by which money could be characterized as being exceptionally tight in 1973. The slowing in the growth of the monetary aggregates was less pronounced than in several other periods of restraint. Moreover, there was very little indication of credit rationing and credit shortages this time—with the exception of housing for a time after June. Although monetary policy in particular, and financial conditions in general, helped encourage some needed slowing in the economy, they at no time produced conditions of extreme restraint.

As for GNP forecasts for 1974, you will recall that last fall a consensus was emerging that the economy's growth would be noticeably less rapid in 1974 but that we would avoid a recession. An October survey of private forecasts showed a median year-to-year rise in real GNP of about 2.5 percent. This would have been significantly below the "normal" growth trend—usually reckoned at 4 to 4.5 percent—and would have been compatible with very small or near zero growth in some individual quarters in 1974.

But then came the Arab oil embargo, and the fall forecasts—which looked quite reasonable at the time—had to be redone. It appears that, on average, forecasters cut their estimates of real GNP growth this year by about 1 percentage point, a significant but still moderate reduction. One survey, taken in December, suggests that most economists were then estimating real growth for 1974 at between zero and 2.5 percent, with many estimates clustering around a median of 1.5 percent. Most of these forecasts apparently assumed that the oil embargo would be over by midyear. Presumably if it had been known that the embargo would be substantially ended by late in the first quarter, the forecasts would have averaged somewhat higher.

If growth turns out reasonably close to the consensus view, one or possibly two quarters of outright declines in output would be a reasonable inference. Also implicit in such a forecast is some rise in the unemployment rate, perhaps to the 5.5 to 6 percent range by the end of the year.

The economic outlook, which is always uncertain, was of course open to an especially high degree of uncertainty this year until the recent announcement that most of the participating Arab countries would remove their embargo on oil shipments to this country. Questions of the impact and duration of the embargo had represented a considerable cloud of uncertainty for businessmen and policy makers. The ending of the boycott should represent a clear gain for the economy.

To sum up, the current picture of the economy is a mixture of clear pluses, clear minuses, and clear question marks: There are still many signs of shortages and demand pressures, together with some indications of reduced demand in other areas. On balance, I would think that we are seeing about what might be expected in terms of the standard forecast—in other words, a relatively brief, relatively mild, and heavily shortage-induced downturn. While this produces problems, it should at least create some breathing space in the economy, something which is absolutely necessary if our really dangerous rate of inflation is to be tamed.

One might question the role of monetary policy in our present situation, where we have rampant inflation coupled with a slowing in the economy that has been, and continues to be, aggravated by various sorts of shortages. In view of what I have said already, it will not surprise you that I believe our number one problem is bringing a highly dangerous inflation under control. It seems quite clear that inflation over the past year or so has been importantly influenced by excess demand conditions and that monetary policy can make an important contribution to relieving this situation. Failure to slow inflation now runs the risk of its further acceleration, accompanied by increased social tensions and, ultimately, serious economic readjustments. As I have already indicated, the current economic weakness appears to me to be localized and relatively minor in proportion. In these circumstances, additional stimulus from monetary policy at this point would seem to pose significant risks. Of course, we must also continue to keep a close eye out for any signs of a cumulating weakness in demand, despite the absence of any real signs of such a development at present.

Looking for a moment at the international side, 1974 presents a wide range of possibilities. There was a substantial improvement in the United States trade position over the course of 1973, with a year-to-year turnaround of about $7.5 billion in our net merchandise exports. Our agricultural exports moved up very sharply. Moreover, nonagricultural exports, including a very wide range of goods, also showed substantial gains. It seems clear that in many areas our goods are once again competitive. Indeed, exports certainly would have been higher if we had had the capacity necessary to produce more.

On the import side, the dollar cost rose significantly further but excluding fuels the real volume of imports, in constant dollars, on balance actually declined between the first and fourth quarters of the year. This decline reflected the significant change in costs resulting from the dollar devaluations, as well as the fact that foreign productive capacity abroad was stretched tight by the worldwide boom conditions.

There are a couple of things that emerge from the 1973 trade picture that may be useful in helping us look ahead. On agricultural goods, the volume of exports held relatively steady following an initial jump in the first quarter, while the rest of the gain resulted from price increases. The general expectation seems to be that our agricultural exports will remain strong.

With respect to other goods, it is clear that we are again in a relatively strong competitive position. As the economy slows and capacity limitations are less of a constraint, we should be able to continue to increase our share of nonagricultural exports. The major uncertainty in the outlook for this area is the level of economic activity abroad, particularly in relation to the impact of oil-related problems on industry, and the efforts that foreign countries may make to finance increased oil bills by expanding exports and reducing other types of imports.

Given the slowing in the United States economy, there is little reason to expect an acceleration of our imports apart from fuels. Imports of smaller foreign cars may rise, but we shouldn't expect that to be a significant problem in the overall picture. Fuels, of course, are another story. All that can be said with any certainty is that the nation's oil bill will grow substantially. It is easy to project an increase of as much as $14 billion in 1974, based on 1973 import volumes and January 1, 1974 prices. But both of these assumptions are clearly open to question. In view of the magnitude of the uncertainties, it is very difficult to guess how the overall balance of trade will come out at the end of 1974.

Looking for a moment at the question of capital flows, it seems clear that the reopening of the United States market for long-term borrowing will lead to a considerable outflow on that account, with recent estimates running from $1.5 billion to $2 billion all the way to $4 billion. However, we could well see a further rise in long-term capital inflows similar to the kind that began emerging in 1973. Moreover, it is likely that some portion of the excess receipts of the oil producers will turn up in the United States directly or indirectly in medium- to long-term forms.

Short-term capital flows are obviously going to be subject to a variety of conflicting forces. There may be some shifting of short-term lending to foreigners from overseas branches to head offices of United States banks as the result of the removal of restraints on bank lending to foreign residents. However, the short-term flows will probably depend greatly on relative interest rates in the United States and in Europe. Relative rates will be affected by how other countries finance their oil deficits and where the oil-producing countries place their receipts. It is impossible to say which way the net flow will go at this point, but it seems likely that with the removal of capital controls here and abroad short-term rates will tend to converge more than in recent years.

Finally, we should spend a few moments on the exchange rate situation. As you are aware, the efforts of the past two years to achieve a comprehensive and formal monetary reform have not been especially fruitful, particularly in the light of recent developments. It has been clear for quite a while that there has been only limited agreement achieved, and even then only in broad terms, with considerable disagreement over crucial operational details. Meanwhile, during the past year we have had a regime of "managed" floating—"managed" primarily by means of central bank intervention. If we add up official intervention in the exchange markets since floats began in March 1973, the total is over $35 billion, a figure probably exceeding the intervention over any similar period under fixed rates. Despite this massive volume of intervention, we have continued to have very substantial and often erratic movements in exchange rates. Considering the events of the past year, both economic and noneconomic, it is doubtful that we could have done better under any other system. However, I don't think that our experience makes a very persuasive case for floating rates. Gabriel Hauge of Manufacturers Hanover Trust Company in New York City put it very well recently when he said:

> Although most economists still appear to favor a floating exchange rate system, careful monitoring of the current experiment in floating has not been reassuring, at least to me. At times last year, the major currencies fluctuated sharply against each other, leading to the kind of highly unstable situation that floating was supposed to obviate. The system made it possible for the dollar to be driven down to an unreasonable level against many other currencies, so that the United States public is now paying the price in terms of added inflation for the instability of the floating rate system. As I contemplate the recent experience with the theoretically appealing case for floating, I cannot but recall Charles Kettering's warning, "Beware of logic; it is an organized way of going wrong with confidence".

In the end it seems rather clear that a major factor carrying the monetary system through the shocks of the past six months has been the general strength of the dollar. Regardless of how many people want a substitute, and how much they want to reduce the system's dependence on the dollar, that dependence inevitably will continue for some time. Consequently, full restoration of confidence in the dollar still remains the key to reasonable stability in the monetary system. As Chairman Burns stated recently to the Congress:

> Confidence in the dollar is essential both to a healthy domestic economy and to a successful evolution of the international monetary system. Looking to the future, we must strive to conduct all our economic policies—domestic as well as international—in such a manner that they will maintain, and indeed strengthen, that confidence.

Confidence is indeed essential. And confidence cannot be won unless and until it can be clearly demonstrated that the forces of inflation—which have been with us for so long—can and will be brought under control. Hopefully, the coming year will see a substantial movement toward that goal.