NATIONAL PERSPECTIVE

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I want to talk about where the economy is, and what the implications are for the outlook, given certain policy assumptions.

Then I want to talk about inflation within the macro-policy, the broad monetary and fiscal policy, considerations. Also I think the micro considerations are all too frequently overlooked or considered unimportant. I am really thinking in terms of the economic structure and those policy determinations which relate to the economic structure.

And finally, I want to talk about inflation and the need for international cooperation if inflation is ever to be successfully resolved. Actions far beyond those which we can bring to bear domestically will be required to purge the world of inflation so that we can begin to plan with any semblance of logic for better living conditions in the future.

In his economic address to the nation President Ford said with rather simple eloquence that the state of the nation was good, but the state of the economy was not so good. That statement sums up a great deal.

Where are we right now? In the first quarter of this year the economy declined at an annual rate of roughly 7 percent in real terms. In the second quarter the rate of decline dropped to under 2 percent, at an annual rate, in terms of real output. Whether we call it a recession or not, the economy is not in good shape. I think that a recession will be at least as deep as the one we experienced in 1969 and 1970.

Any recovery in the durables sector, which is principally being led now by a revival of automobile sales, is largely illusory. Real purchasing power continues to suffer as a consequence of inflation. Income growth, in nominal terms, still remains quite slow. Since we are now anticipating an increase of at least $450 to $500 in average per unit price of new automobiles in 1975, the recent improvement in durable goods sales, particularly automobiles, is at the expense of the 1975 model year. I do not think that we can take any great solace from the fact that Americans have concluded that the 1974 automobiles represent a better buy. Belatedly the industry is coming to this conclusion. By the time the 1975's roll out on the streets the price differential, on the average from the 1973's, will be $1,000, and in many instances far more than that. The real income of consumers will be substantially lower than it was two years ago. Under these circumstances it is rather difficult to forecast any appreciable improvement in this component of durable goods.

Consumer spending on other durable goods, such as furniture and appliances, is also likely to slacken because of the related weakness in the housing market. There is very little prospect that we are going to see any appreciable improvement in consumer spending for durable goods. Quite frankly, we will probably see a further deterioration from current levels for the remainder of this year.

Now, turning to the investment sector, we find some very serious questions. The housing industry is not concerned with defining a recession; by any definition it is in a pronounced depression. Housing starts in July were running at an annual rate of little more than 1.3 million units. This is about half of the number a year earlier. Housing permits, which offer some advance indication of what activity levels are likely to be some months down the line, were roughly 40 to 50 percent behind a year earlier. We may yet see a further drop in housing starts to an annual rate of perhaps a million units by year end. Housing starts for the year as a whole will probably average under 1.5 million units. Last year they averaged 2.1 million.

This situation, of course, is a consequence of a variety of factors, especially the incredible increase in the median price of new housing. In four years the median price of a new house has risen 50 percent. The median single unit dwelling price in America today is about $35,000. And if anyone is looking for something under $20,000 to $25,000, chances are nine out of ten that he is going to have to settle for a mobile home. We no longer build, to any appreciable degree, the kind of houses that used to represent for many the culmination of the American dream—one's own single family home. As we look around at the garden apartments and condominiums we may, in fact, be seeing the shape of future residential dwellings in America.

Construction costs have been rising tremendously. Interest costs and mortgage costs have also been rising. For all practical purposes, unless sellers of existing houses are willing to pay a very substantial penalty in points, they are just not going to find people in a position to deal for their houses. So the housing situation is grim and is likely to get grimmer irrespective of anything the Federal Reserve System does.

In terms of capital investment, planned expenditures for 1974 will now be about 12.5 percent larger than for 1973. This represents a modest revision from the earlier surveys. We have to remember that capital investment is a lagging indicator; it tends to peak out and turn down well after the economy has itself turned down. It is conceivable that despite what still looks to be substantial strength in this area, we are going to see some weakening from these anticipated figures.

The most important consideration that poses potential trouble for the American economy is inventories. Almost every business cycle can be construed as an inventory cycle. Since inventory adjustments lag behind changes in sales, at some point inventory has to be adjusted downward just when the economy is quite soft. This simply compounds the situation and turns a flat economy into a declining economy.

We thought that inventory accumulation for the first three quarters of last year was proceeding at roughly an annual rate of $4.5 billion. Then with the onset of the October war in the Mideast, the oil embargo, the public attitude against purchases of large automobiles, which contributed very substantially to buildups, the rate of accumulation jumped from the presumed $4.5 billion to $18.5 billion, or rougly fourfold. We explained this in part by the automobile situation, which led many people to conclude that the only problem the economy was suffering was an energy-induced problem. Harry Dent, the Secretary of Commerce, said, "The American situation now is not a recession; it's an energy-induced spasm."

In fact, our problems were not stemming wholly from energy; they were simply being compounded by it. But many people looked at what happened to automobiles and said, "Well, that accounts for the inventory situation." But, when the second quarter preliminary gross national product (GNP) figures were released with revisions for previous periods, they showed that for the first nine months of 1973, instead of averaging a $4.5 billion accumulation, it averaged $10 billion. And the fourth quarter figure was not $18.5 billion but $28.5 billion. Meanwhile the growth in real output of the economy dropped from 9 percent in the first quarter to 1 percent in the fourth.

By the first half of 1974 we had already undergone a substantial inventory adjustment, which in part contributed to the big drop in real growth in the first quarter. Inventories are now estimated to be accumulating at an annual rate of about $15 billion. So we have cut the rate of accumulation by half.

As I look to the future, the weakness in consumer durables, the weakness in housing, the potential weakness in capital outlets, suggest weakened demand. Then the implications of this inventory outlook become potentially very bothersome, particularly when we consider that the mechanics of accounting for business sales and accounting for inventories are quite different. Business sales, which for the first time in four years declined in July, are valued in GNP accounts at current market prices. Inventories are determined by their book value. This means that there is a built-in tendency in a period of rising prices to understate the physical volume of stocks on hand. And, to the extent that we are expecting substantial inflation in the future combined with a likelihood of a further deterioration in final sales, inventories could be a very serious damaging and depressing factor in the outlook.

Turning to government spending, when we take into consideration the receipt of revenue-sharing funds plus federal, state, and local government spending, these governmental units combined will probably be running a small surplus. In terms of the total impact of government spending on the economy, this small surplus is going to be somewhat restrictive. Surpluses tend to be restrictive, even as deficits are stimulative. There will be increases in state and local government spending. But because of present capital and money market conditions and interest rate constraints, we are going to be seeing more than the normal amount of deferrals at state and local government levels, in terms of capital projects.

There is a strong push to cut or at least limit federal expenditures for the remainder of this fiscal year as well as the fiscal year beginning July 1, 1975. President Ford has indicated he hopes to cut federal spending from the projected $305 billion to $300 billion. There is some question whether this can be done. There is some question in my mind whether the reduction will even be appropriate. But the thrust of government spending is at this moment biased a bit toward restraint rather than stimulus.

What does this suggest for the outlook? It suggests that real activity levels are likely to decline further for the remainder of 1974 and perhaps into early 1975. We can only hope for very modest, if any, increases in real economic growth beginning in mid-1975. We are likely to see a continuation of the rising trend in unemployment. By 1975 I would expect it to exceed 6 percent.

When confronted with an incipient recession or continued economic slack and rising unemployment, the response in times past has been quite clear. Fiscal policy has moved toward stimulus, and monetary policy has moved toward easing. That is the kind of policy prescription that would be called for if the only consideration were the economic outlook I have described.

But, as you know, these are not normal times. With prospects for the economy as grim as I have described, we have to superimpose on this the equally grim prospects for price inflation. We may still be seeing rates of inflation as measured by the GNP deflator of at least 8 to 9 percent by year end. Price inflation in the second quarter of this year, at an annual rate, was 9.6 percent, down from a little more than 12 percent in the first quarter. I will take issue at this point with the expectation that we can bring inflation to its knees by July 4, 1976. The best I can hope for is that the process of returning this economy to some modicum of stable prices might be under way by year end and that it will continue through 1975 into 1976. I have no expectations whatsoever that we will see an inflation-free economy by July 4, 1976, unless we are willing to pay a much higher price in terms of recession and slack than any of us is prepared to pay.

We are faced with a dilemma. The economic situation clearly calls for one set of policy prescriptions, while the price situation clearly calls for something else. It is in this regard that I think the micro-economic or micro-policy considerations are most important.

It is disturbing to me that in any analysis of today's inflation combined with today's recession, we find almost a total exclusion of considerations of economic structure in the United States. We find instead allusions to crop shortages, fertilizer shortages, energy crises, and the like. The incredibly strong worldwide demand last year contributed to inflation, by kicking up the prices of raw materials. The energy crisis, which resulted in tripling and quadrupling of the price of crude oil, has accelerated inflation. These other considerations such as crop shortages have contributed to inflation. But in 1969 and 1970 we experienced a recession with accelerated inflation, and in 1974 we are again experiencing a recession with accelerated inflation, which is being aggravated but not wholly caused, by those factors which I have mentioned. There is something about the American economy that does not seem to work like it used to.

First, however, I want to talk about the macro-policy considerations. These are important. But, in a sense, they are constrained by the micro-policy considerations. There is no mystery about how to manage an economy in terms of increasing aggregate economic activity. That is a cinch! The fact is, Keynes said something quite profound and quite simple when he said that spending creates income. It is as simple as that! Spending is what creates income, and an absence of spending will deteriorate income. If we want to hypo an economy up, all we have to do is pump something into it and get people to spend. On the monetary policy side, it means making money and credit more readily available. On the fiscal side, it means either cutting taxes or increasing expenditures. Anything to increase aggregate demand will ultimately increase income.

On the other hand, we have learned a lesson, which I hope will cause economists to have a greater degree of humility, and that is, it is not so easy to turn an economy off when it gets to going at an excessive pace. That is the lesson that should have been learned, but was not learned. And it is in that regard that the constraints upon the ability of monetary and fiscal policy to do their job hinge so much on micro-policy considerations. If, in fact, we can increase aggregate demand to increase real output, we can, theoretically, induce more slack in the labor and product markets to get price and wage pressures down. That is assuming that all inflation is a demand phenomenon and is caused by excess demand.

If that were the case, we would have no problems. The fact is we are learning that inflation is not wholly a demand induced phenomenon. There are supply constraints independent of demand factors, and this complicates our search for stability.

Public policy, whether it is fiscal or monetary policy, when construed for stabilization purposes, implicitly assumes that those policy initiatives and actions are going to work their way through the marketplace to product markets and to labor markets, to remove excess price or cost pressures. If the key component, a well-operating competitive product and labor market, is absent, then it does not matter how hard we push on those policies. All we are going to get is more unemployment and more slack and only modest improvement in prices and cost.

That is what prompted President Nixon in 1971 to undertake an incomes policy. The reason was that the economy just was not responding to normal policy. Then as soon as the incomes policy was undertaken, fiscal and monetary actions which excessively stimulated the economy undercut the prospects for relief from the incomes policy.

Whatever the structural problems are in the economy, monetary and fiscal agencies still have a responsibility to do the best they can. And any economic imperfections do not relieve these agencies from their statutory responsibility. The Federal Reserve System has a job to do, and it is not a pleasant job. The federal government has a job to do, and it is not a pleasant job either, for its restraints lead to slack and increased unemployment.

As we talk about unemployment as a cost of price stability, we are talking about human beings, we are talking about the loss of dignity that goes with the loss of employment. It is not something that we should accept too lightly. If public policies are going to induce unemployment deliberately, then public officials have a responsibility to mitigate the effects of unemployment and to spread the burden of that unemployment. Whether it means increased public employment programs, increased expenditures for manpower training, liberalization of unemployment benefits and the like, this must go together with any stabilization efforts. We have to keep in mind that those people who cry hardest for price stability are typically not in the front ranks of the inflation fighters on that unemployment line.

The Federal Reserve System, as I see it, is clearly constrained. It cannot do a lot. If it turns around from its present policy stance and expands the money stock substantially to bring interest rates down in the short run, it is going to contribute further to the existing inflationary pressures because it is going to intensify demand pressures in some areas that are already running at a pretty good clip.

Similarly, this is not the time for dramatic fiscal policy actions designed to cut down inflation. Fiscal policy can do only a nominal amount, given the dimensions of the cut being discussed. I personally would not object to a modest deficit at the federal government level. I think that the economic situation probably requires it. It is over the longer run that we have to be concerned with this proclivity for the federal government to continue to spend more income than it takes in through taxes.

The government's tendency to deficit spend only reflects the public's same tendency. The American people have always been told they can have instant gratification without having to worry about paying. And it is much easier to recommend a tax cut than a tax increase. Name the politician who will run for office on the grounds that we have to increase taxes and pay for our public wants and our public demands! I am not against public wants. I am not against public demands. But I am for somehow matching those wants and demands with an ability to pay. The American people have to be made aware that just as private goods cost money, public goods cost money too. In the long run, we cannot indulge ourselves without picking up a very large due bill in the form of inflation.

If there is very little that can be done in the way of dramatic policy thrusts, then we have to turn our attention to micro-policy considerations. One question that should be asked, and is not asked often enough, is why or how can an economy simultaneously experience a recession and accelerated inflation. The only way it can happen is if market power, whether it be labor market power or industry market power, has reached the point where sellers of resources or sellers of goods and services can to a substantial degree set their prices independent of market considerations. We do not have to look much farther than the American automobile industry to see a classic case. If any of us were operating a business that was in as bad shape as the auto industry was last year, we would not conclude that this was the most propitious time to raise the selling price. Quite the contrary! Yet now we see substantial increases in view. Why? To protect profit margins.

The marketplace is presumed to operate on the assumption that those profit margins sometimes get eroded and that actual profits may just disappear when sales disappear. That is the way the market is supposed to work. But in many instances it does not work that way. If we go to the labor market side, we see the same thing happening, particularly with craft unions in construction. The "discipline of unemployment" does not exert the same pull on a craft union in construction as it does on an unorganized area in the American economy. We have permitted economic concentration at the industrial level, and in many instances in the labor market, to proceed to the point where the kinds of downward price and cost flexibility that were assumed to exist in the competitive model no longer can do their jobs at present levels of slack. If we want downward price and cost flexibility, we are going to have to accept a lot more slack than we are willing to take right now.

So the matter, then, of a micro-economic policy called antitrust is something that needs renewed attention. We should begin to ask ourselves the hard questions of whether or not the public interest is well served by the industrial structure and the labor market structure which presently confront the American public. I will say, categorically, the answer is no, it is not being well served. If the world is what John Galbraith described, in his *New Industrial State*, as one in which we are going to have two clear planning components in the economy, a government and a private sector, then I say that is not acceptable to me. If the market forces are not going to do the job, then I am not going to rely on the good graces and beneficence of private entrepreneurs or labor leaders, no matter how big they are, to look after my best interests.

I would say, let us be honest about it, and instead of having something called state capitalism we may as well just take the thing over and run it in the public interest and call it what it is, namely, socialism. And I say that without any pejorative connotation of the word—merely to express a simple reality. If, in fact, Grumman Aircraft Corporation or Pan American World Airways cannot hack it in a competitive world, then I say fine. Do not bail them out. If we need them, make them what we make other segments that we need that cannot work in a competitive marketplace. Make them part of the United States government and give the taxpayers a voice. At least make the costs explicit.

There is the matter, too, of trade policy. Unfortunately, the present economic situation is bringing out the worst in us. In an environment of floating exchange rates, which I find to be at least acceptable in a free market sense, we are now looking at a revival of mercantilism. Under mercantilism, countries pursue beggar-thy-neighbor policies to raise exports and cut back on imports. We find ourselves, instead of looking for relief for the American consumer in the form of lower priced imports, talking now about imposing higher taxes and higher quotas and higher trade barriers. And other countries are doing likewise.

The prospect of competitive devaluations in the face of inflation worldwide is a prospect that should keep each of us concerned, because that prospect carries with it the danger of a substantial worldwide decline in economic activity such as took place in earlier times.

Our own government, in terms of its regulatory agencies and policies, has also contributed very substantially to the present inflation. And there is something that can be done at the stroke of the President's pen, urging a substantial and comprehensive examination of regulatory agencies and their policies to see whether they are consistent with competitive markets and price and cost relief in the American economy. There is no reason whatsoever for a common carrier that operates under the regulations of the Interstate Commerce Commission to take one load from New York to Los Angeles and be forced to drive that rig back empty as a condition of a certificate of public convenience and necessity. It makes no sense in terms of economic reality. It certainly makes no sense in terms of an energy crisis.

We have to be very careful that if we fail to address ourselves to these fundamental considerations at the micro-policy level, we do not fall into the trap of concluding that the only thing that can save us is controls. American agriculture is well acquainted with controls and the distorted effects of those controls. We cannot half-control an economy or quarter-control an economy. We have to totally control the economy. That has not worked in the Soviet Union. In an economy as complex and as free as ours with the competing wants we permit among Americans, it is impossible to construct a set of controls that could more equitably and intelligently allocate resources and distribute income than a well-ordered marketplace.

In the final analysis, whatever costs may be involved in undertaking this critical micro-economic policy examination and efforts, in the long run that cost is much smaller than the cost of permitting the economy to keep lurching along with built-in and increasing inflationary biases. This is not the way to provide a measure of security whether for consumers or wage earners or businesses. It does not provide a planning horizon that makes any sense at all.

Inflation is a worldwide disease. It is only going to be countered by worldwide international economic and financial cooperation. In a world in which we become increasingly aware of the finiteness of our resources, increasing attention will have to be paid to equating those demands which can be reasonably satisfied over a long period of time with the resources to satisfy those demands. The unlimited economic growth horizon that the world has been pursuing for a long time is fading into oblivion. As a consequence of increasing raw goods scarcity, the economic costs of growth, which have clearly been demonstrated thus far to be very high, are going to be even higher in the future. The world is going to have to sit down and say, how on earth are we going to grow, and grow in such a way, that there is something left for posterity both in terms of real resources and in terms of a quality of life that future generations can enjoy.

Limited resources raise the question of the developed world's responsibility toward the underdeveloped world in terms of resource sharing and resource distribution. Also, when the realities of limited and costly economic growth become apparent, the matter of income redistribution, which has so long been ignored in this country, is going to have to be examined in a very serious way.