Allan Greenspan

I: The Problem

Our society has made progress in many selected areas in recent years. We cannot say, however, looking back over the past decade that we have become on balance a more content people. We have lost some of our enterprise, our drive and our pride. The social cohesiveness which cements us together as a nation has weakened.

This country's position as a world economic and military force has slipped perceptibly. For decades the rest of the world held us in awe and respect largely because of our economic power and the military capability which was a consequence of that power. International respect, whether we like it or not, is based on power and the ability to achieve national goals and objectives in the external world. Regrettably, admiration based upon good deeds and good will count for little in today's world.

As our capabilities have waned, our vulnerability has increased. Respect has been replaced with animosity and even hatred, as large elements of the rest of the world have turned upon the United States. The appearance of this latent hostility (evidenced, for example, at the recent World Food Conference and at the U.N.) has further undermined our ability to secure our national goals and objectives.

In the world's marketplace the petroleum exporters, emboldened by our growing vulnerability and our inability to deter their actions, have embarked upon a concerted and successful effort to reduce production and drive prices up. The oil cartel has imposed a vast artificial drain on the resources of the industrial countries which threatens to tear apart the fabric of the financial structure of the world.

Producers of bananas, coffee, copper, iron ore and a wide range of other commodities are now examining the possibilities for exercising their own market power. Obviously, at the moment, most lack the solidarity of the oil producers so that sharp proeuction cuts and price increases are not likely in the immediate future, but the growing U.S. reliance upon imported raw materials will make future cartels more probable and more effective unless the deterioration in the U.S. position is arrested.

The change in foreign attitudes toward the U.S. has also been evident in the wave of hostility toward our foreign investments which have resulted in the growing tendency of expropriation. Regardless of the adequacy of compensation, this change, signals different conditions for the future -- a lessening of U.S. control over raw material sources that are essential to modern industrial society. As the past several years have shown, we have become powerless to counter this trend effectively. The situation will continue to worsen so long as the economic power of the United States continues to wane.

II: Its Causes

There are many origins and proximate causes of the decline in our economic power. But the most important is the dramatic change in social and political philosophy that we as a nation have implicitly embraced. In little more than a decade, we have moved from a political philosophy which considered economic fine tuning an inappropriate Government function to a point where the price of popcorn became for a while something for which the Government was ultimately responsible.

As recently as the early 1960's the predominant view was to allow market forces free rein. The direct intervention of the Federal Government to alter the patterns of economic activity or the distribution of income engendered by market forces had only modest support. But dissatisfaction had been building up for decades, largely among the intellectuals and the social scientists who, by some arbitrary standard, considered the spectacular success of our economy to be inadequate. Many deemed the fiscal and monetary policies of the 1950's unadventuresome and promised great rewards in accelerated economic growth for what later became dubbed economic fine tuning. By 1963 President Kennedy was sufficiently convinced to press for large tax cuts and programmed Federal deficits to "get the economy moving again." Ironically, the successful dissipation of inflationary imbalances during the Eisenhower administration had created "reserves" which could be "cashed in." Accordingly this tax cut program "worked."

The economy accelerated and the heralded "success" of the Kennedy program changed the politics of economics. It set into motion a period of frenetic economic policy activism which has persisted down to the present. The current unstable inflation-ridden economy is one of its legacies.

Granted the biases of large Government toward activism and low unemployment, the rapid progression toward inflation and controls could scarcely have been otherwise. New Federal expenditure programs proliferated through the 1960's and soon fully mortgaged the so-called fiscal dividend for the indefinite future. Budget deficits ballooned and inflation took hold. Admittedly, the Vietnam war was a factor, but it was a minor factor when compared with the explosion of social programs which was the real source of fiscal deterioration. Given the nature of political decision-making by 1971 wage and price controls became inevitable.

When decisions are reached in the private sector to build new plants or develop new markets, present and future costs are traded off against present and future benefits.

Political decision-making, on the other hand, has become short-sighted, particularly in its single-minded focus on short-term benefits. Potential longer-term problems, seen emerging from the nearsighted programs, are dismissed as something which hopefully will never arise, or, if they do, can be handled by some new program (or different politician).

Government's professed responsibility of recent years for every detail of economic activity, when coupled with the warped approach of the political process to cost/benefit trade-offs, leads inevitably to action by crises only. It is only when a problem reaches the crisis stage and the "hope" that somehow it will just go away becomes no longer credible, that action is demanded. However, a crisis solution by its very nature is short range. It comes to grips with nothing but the immediate manifestations of a problem.

Invariably secondary crises soon arise as a consequence. A general price freeze, for example, bottles up inflationary forces to be released at a later date. A price ceiling discourages supply expansion which eventually leads to much higher prices. Explosive pump priming to curb recession engenders accelerated inflation at a later date. Even when the political decision-makers are aware of these later adverse consequences, they implicitly place an exceptionally high rate of time discount on the longer-term adverse effects. Activist economic policymakers soon build a large backlog of "bridge crossings when we get to it." Soon even the alleged short-term benefits fade as the formerly longer-term costs begin to be experienced with the inexorable turn of the calendar. The cumulative costs of policy soon overwhelm the cumulative benefits. We have just about reached this stage.

As might be expected as a consequence of economic policy activism, an ever larger proportion of the national income has been absorbed by governmental programs. Total governmental outlays at all levels (federal, state and local including transfers) absorbed almost 32 percent of our GNP during 1973 and the final figures for 1974 will surely show a further increase. By comparison prior to World War II total government absorbed less than one fifth of GNP.

Expenditures by the Federal Government lie at the heart of this huge shift. On a fiscal year basis direct federal outlays rose by 57 percent between 1952 and 1962 -- slightly more than one-half. Between 1962 and 1972, however, federal outlays more than doubled, rising by 117 percent. Between 1972 and 1975 direct federal outlays rose by an additional 30 percent. Federal expenditures are now increasing at a rate in excess of $30 billion annually, an amount equivalent to the entire federal budget only two and one half decades ago. And we must note that this says nothing about the proliferation of federally sponsored agencies and off-budget activities that have been added to the picture since the early 1960's and the explosion in the expenditures for these programs.

During the past five years (from 1968-73) for which information is available the expenditures (the gross borrowings) of the off-budget agencies rose from $3 to $20 billion -- thus adding an additional 2 percentage points to the share of GNP controlled by government. Nor does this share include any allowance for the costs imposed through the mandate of government for safety, environmental and other legal standards. These costs are exceedingly difficult to measure, but official estimates of pollution control expenditures suggest that the capital costs alone of efforts to comply with water and air standards are currently running in excess of $6 billion per year, and I suspect that these estimates fail to capture the bulk of the mandated expenditures.

Over the past decade the Federal outlay problem has taken on near-uncontrollable dimensions. A large and growing proportion of total outlays is the result of past programs or programs that are already on the books. Such outlays are virtually uncontrollable or are mandated without changes in the underlying legislation. At present some three-fourths of total federal outalys are "virtually uncontrollable" up from less than 60 percent a decade ago. The portion of the budget subject to discretionary control has shrunk because of two reasons (1) the relative decline in defense outlays (which are generally controllable); and (2) the huge increase in mandatory grants to state and local governments and in transfer payments to individuals and families, a large portion of which are set by law.

Federal transfer payments have been increasing at astronomical rates. Measured in current dollars federal transfer payments to persons rose from $25 billion to $75 billion between 1962 and 1972. Since 1972 they have increased to about $120 billion, equivalent to almost 40 percent of the budget. In constant dollars transfer payments to individuals rose by 8 percent annually between 1962 and 1972 -- more than twice as rapidly as did real GNP. During the past three years the rate of increase was 10.4 percent per year. Grants to state and local government tripled in constant dollars during this period. As a consequence, transfers to persons and to state and local governments accounted for 47 percent of government outlays in 1972 and by 1975 this share is projected to rise to 58 percent. Burgeoning transfers have been financed in recent years by sharp declines in defense expenditures in real terms. Constant dollar military outlays as projected for fiscal 1975 will be a full one-third below 1968. This has obviously become an area of the budget which can no longer be cut with impunity. Unless the uptrend in transfers is curbed, therefore, we will either confront huge deficits and strong inflationary pressures or sharply rising tax rates.

In addition to the existing programs there are the inevitable new ones. The normal workings of our government, both the Legislative and the Administrative branches, create new programs year after year. Action is the very essence of contemporary government and this produces an annual increment of new programs -- another type of uncontrollable which makes the rise in outlays virtually unsuppressible. One cannot say beforehand what bills will be passed during the year just as a result of normal government procedures or at what cost, but recent experience suggests a large unspecified increment to outlays which is strictly a function of the fact that our government meets and functions virtually all year long, creating new programs and initiatives. It is less of a surprise then, that the large fiscal dividends, whose arrival at some point three to five years out is regularily promised, never materialize.

I frankly do not believe that we are fully aware of the depth of the problem we have inherited. Its significance to the future of American society cannot be overemphasized.

Stated simply, federal spending is developing a seemingly inexorable rate of growth that is far in excess of the growth in taxable income. To maintain any semblance of a budget balance will require that spending growth be curbed or taxes as a percent of any definable tax base rise indefinitely. The American economy will face not a single choice of inflation versus a tax increase but a whole series of tax increase decisions extending indefinitely into the future.

Tax rates cannot continue to rise indefinitely even if the American taxpayer were willing (which he isn't). At some point, which is no longer far distant, economic growth will be repressed by excessive tax burdens, and higher tax rates would no longer yield greater real revenues. Thus, raising taxes is not a solution, but a delaying tactic. All it does is postpone a solution.

The source of the problem is the ever expanding number of what I like to call "fiscal constituencies," e.g., groups of individuals receiving payments in cash or in kind on a continuing basis under an on-going federal program. We now have tens of millions receiving Social Security, veterans' benefits, farm subsidies, public assistance, etc. and the list is growing.

Aggravating the problem of the expansion in fiscal constituencies is the seeming impossibility of eliminating or even paring programs once they are underway. Curtailments do occur, but only rarely. As a general rule, the number of individuals included in a fiscal constituency and the amount of funds received tend to behave as a ratchet -- always increasing or holding stable, never declining. Whether a particular program actually resolves the problem to which it is addressed appears to be of little moment once the constituency has formed.

So long as government functions are general and citizens have a diffuse relationship with their government, the problem of fiscal constituencies is limited. But, as soon as strong associations with specific programs emerge, the pressure on the Congress and on the Executive branch to expand these programs and to create new ones becomes irresistible.

A related problem is the issue of tax reform. All taxpayers seek lower taxes and it is not an accident that every time some tax bill emerges, the pressure is to reduce taxes, thereby augmenting deficits for many of the same reasons that have engendered the proliferation of fiscal constituencies.

III: Some of Its Consequences

A. On Savings and Investment

It might at first appear that the confrontation on fiscal issues is between the constituencies and the government. However, the government is a mere intermediary. When this becomes clear, we will experience a further polarization of societal groups which would severely threaten the community of interests and the sense of unity which have kept this nation together.

An advanced capitalist economy simply cannot effectively function under the short-sighted policies inherent in economic policy activism. The built-in crises ultimately undermine savings and capital investment and, as a consequence, economic growth. At the end of the activist road is economic regimentation.

The philosophy of economic activism with its special stress on short-term benefits has institutionalized an implicit view that there is a cornacopia of goods and services which is available to all. Concepts of thrift and creating reserves for "a rainy day" are apparently now considered irrelevant cliches. In recent years we have seen many cities and states spend every revenue dollar in sight. The consequences are now apparent (for example, in New York City).

But the loss of thrift has prevaded our whole economic process. Investment and savings are that part of the nation's output which is diverted from current consumption for the purpose of improving the nation's capability to produce and consume more in the future. It is only by diverting part of current output into investment that standards of living can be maintained -- let alone improved.

It is only through investment that productivity-increasing advances in science and technology have been instrumental in lifting productivity and standards of living. It is only through investment that new workers can be absorbed into our economy at least at the level of real incomes and wages to which we aspire and which we demand. In 1973, with the economy laboring along under strained capacity and shortages the average U.S. employed worker had in excess of $20,000 of investment at his disposal. Our labor force has been growing at an accelerated rate in the past decade, and yet we have not stepped up the pace of investment in a corresponding way. We are not increasing the capital stock per worker rapidly enough to lift productivity, especially since part of our capital has been absorbed in environmental mandated facilities.

The incidence of product shortages has begun to ease as the economy has declined. Capacity today appears adequate -- but we know that when better times return that the capacity shortages will reappear long before the economy is back at full employment in a labor utilization sense. We know, moreover, that productivity will rise but not rapidly enough to provide the increased volume of goods and services that our population expects. For this we must step up investment. We also know that inflation has produced some serious distortions in the nation's capital stock. We know that our capital stock has aged and that obsolescence is widespread throughout the basic industrial and the transportation sectors.

B. <u>On Inflation</u>

In addition to its effect in holding down productive investment, fiscal deterioration has also been the direct underlying cause of the upwelling of inflation.

The price level is essentially a financial phenomenon. Averaging out over periods as long as two or three years, inflation is the direct result of changes in the unit money supply, i.e. money supply per unit of output.

The relationship between prices and the unit money supply is close both in the United States and abroad and it extends backwards into time for as long as our statistics will reliably carry us. Simply stated,the more money that is in the hands of people in comparison with the amounts of goods being produced, the higher will be the price level. The money supply is, moreover, capable of being controlled in a technical sense and with a fair degree of precision. But this is not the entire answer because we must ask why it is that the quantity of money on occasion departs so widely from the desirable level. Why is it that pressures have forced the Federal Reserve to accommodate much larger increases than it would otherwise sanction?

While it is difficult to separate the several complex elements, in my judgment, the major factor by far has been the spillover of credit requirements from the capital markets as private business has been unable to fully meet its credit needs owing to the rising proportion of our basic savings flows that have been preempted by federal, state and local governments. I am referring not only to the direct borrowings of these governmental bodies but also to the borrowings of the many Federally sponsored agencies outside of the budget, and the borrowings of private companies needed to finance the facilities required to meet the legislated environmental control standards and similar mandates.

This type of borrowing has some special characteristics which have a quite different type of effect on capital markets and interest rates than does the vast bulk of borrowing by private industry and individuals. The U.S. Treasury will borrow whatever is required to cover its deficit wholly independently of the prevailing rate of interest as will most state and local governmental units and the off-budget federally sponsored credit agencies.

What this means is that such borrowings have first claim on the flow of private savings and hence leave less available for the normal borrowing requirements of the private sector. Unwilling and unable to compete with the public sponsored borrowings, private borrowers have been forced to the commercial banks for accommodation. There are obviously many other elements in the process but I believe that the major source of the pressure on our money supply growth and price level has been the acceleration in federal and federally sponsored borrowings.

IV: The Major Remedies

A. Education

I do not underestimate the gravity of the problems confronting this country nor of the momentum that has been built up in favor of economic policy activism. However, it is important to recognize that the essential tenor of

American political opinion is largely conservative (evidence, for example, the 1972 elections). It is most unfortunate that our political system has made it appear that somehow economic benefits can be created out of nothing. Were the American people made fully aware of the costs associated with the benefits proferred them during the past decade, their choices, in my judgment, would have been considerably different.

It is, therefore, vitally important to educate the American public on the policy actions required to restore our economy. We must communicate the real choices which confront the American people in the years ahead so that they can choose among real alternatives. The demagogic options to which we have been subjected for far too long will no longer do.

The task is exceptionally difficult, but to fail to exert every effort in this direction is to do a grave disservice to the future of our children and our children's children.

B. Policy

The first order of priority is to outline what specific long-term policy actions are necessary to restore economic equilibrium. However, we will never resolve the long-term problems unless, and until, we confront the very serious short-term economic problems. It is essential, however, that the short-term policy strategy be consistent and continuous with the economic policies that are required to restore long-term equilibrium.

C. Long-Term Budget Control

The critical element in any long-term stabilization program must be a leveling off in the proportion of private savings flows preempted by governments and their agencies. A reduction would be even more desirable. It is, therefore, mandatory that the growth both in federal budget expenditures and the off-budget financing and credit guarantees be restrained.

This would reduce the inflationary instabilities of excessive money supply creation, but equally important it would assist the financing of private capital investment. It is clear that the same process of credit preemption caused by exploding budget outlays has also been a key obstacle to the expansion of capacity. Ideally the federal government should be adding to savings through surpluses in the unified budget instead of preempting them through deficits and expanding off budget and credit guarantee programs. Expanding the flow of savings into capacity increasing investment must be a vital consideration in any anti-inflationary program and this cannot be done effectively without a restoration of longer-term budget discipline. Obviously then, the first order of business must be consistent year-in and year-out budget control.

Over the longer run the only way to bring down the rate of increase in federal expenditures is to somehow tie the costs of new programs directly to the benefits which such programs will provide. Those who will benefit from a new program must directly confront those on whom the costs of the program will be imposed. It might be useful, for example, to require a program sponsor to also propose a specific source of revenue to finance the program or alternatively to propose the deletion of other existing budgetary programs.

Hopefully the joint consideration of the costs and the benefits would help create the same degree of fiscal discipline for the federal government that exists, for example, in the local school district where the voters have a much greater degree of control over outlays.

In practice this might require a whole series of separate surtax revenue bills passing through both the Ways and Means and Senate Finance Committees. A failure of the revenue portions of the bill would automatically defeat the expenditure bill. This raises numerous problems of estimating the costs of particular legislation, converting those costs into tax equivalents and forecasting the income tax base in order to calculate the surtax rate which will yield the additional revenue. But these problems can be solved.

The obvious loophole and major problem with such a procedure, of course, is that some way must be found to prevent the Congress from rescinding the myriad individual tax increases which it has voted during the year with one omnibus tax cut bill at the end of the year.

Serious consideration should also be given to significant reductions in the withholding tax schedules. The payment of a much larger proportion of an individual's taxes in a lump sum final payment in April would probably create a much more expenditure conscious Congress by creating a much more tax conscious electorate. By making tax payments more visible taxpayer pressure would be increased.

One approach that might be considered (from Paul O'Neil) would be to have a portion of the revenue sharing payments to state and local governments conditional upon an escalator that would be activated by the appearance of an end of the year surplus in the federal budget. Another suggestion of his would be to have some form of tax relief to the individual taxpayer made conditional upon the actual attainment of a budget surplus at the end of the year. This would also add to the development of constituency pressure against expenditures.

In any event a study group or commission is needed to detail the long-term budget reform which will be required. The new budget reform act is only a start in the right direction.

D. Financial Reform

One consequence of the sharp increase in corporate tax rates (in the wake of World War II) and the deductibility of interest but not of dividends from taxes has been a predictabl sharp increase in the proportion of external corporate financing with debt instruments. This has created a dramatic rise in debt-to-equity ratios for American business over the past quarter century. Because profit margins were high in the immediate post-World War II years, the creation of internal equity capital through the plow-back of earnings prevented a rapid deterioration in the financial structure of American business. However, profit margins (excluding the ephemeral inventory profits) have deteriorated sharply in recent years even before allowance for the very substantial underdepreciation of fixed corporate assets. Unfortunately, the erosion of profit margins is occurring at a time when the worsening debt equity ratio has made a very substantial increase in external equity financing imperative. Obviously the decline in the stock market has further worsened the situation. Many corporations are now in a position where they cannot raise adequate funds to finance needed capacity without making substantial sales of new common stock. Hence an important part of any program must emcompass ways to enhance the sale of equities.

E. Short-Term Policy

Short-term policies must focus upon the serious short-term problems but in a way which does not in and of themselves undercut our essential long-term goals. In fact, short-term difficulties often present opportunities to initiate changes in policies that will help secure long-term goals which we should take advantage of. Incentives for business investment and job creation for the private sector have much higher chances of passage during periods of deteriorating corporate profitability. Several possibilities deserve special consideration.

(1) A sharp but perhaps temporary increase in the investment tax credit to 15 or 20 percent in order to help sipport capital appropirations and outlays during the second half of 1975 and calendar 1976 when investment outlays are likely to be weakest. However, the investment credit should subsequently fall back to the long-term 10 percent rate since there are far better uses of tax concessions to the business sector

than a permanent 15 or 20 percent investment tax credit.

(2) In addition to our already proposed deductibility of preferred stock dividends, we should propose that some portion of common stock dividends be deductible by corporations (perhaps somewhere between 30 and 50 percent). This would be of material assistance in redressing the imbalance between the costs of debt and the costs of equity capital and helping resolve one of the major financial problems confronting American corporation -- the inability to raise adequate equity capital.

(3) There should be a significant across the board cut in individual income taxes. The extent to which the tax cut is disproportionately greater in the lower income ranges of the tax schedule should depend upon the extent of the curtailment of Federal outlay and transfers which go to the lower income and the non-taxpaying groups. If we do not propose a substantial cut in Federal spending from the currently budgeted levels, the personal tax reductions should be proportional. To do otherwise would merely further the disincentives toward the savings and investment which are now so necessary. There should be a disproportionate scaling down of the withholding schedules effective retroactive to January 1 coupled with the personal tax reductions. This

would have the dual advantage of combining short-term tax relief with a move toward a higher proportion of taxes being paid in the final settlements tax payments in April 1976, and the probable increase in taxpayer pressures to hold down government expenditures.

(4) Fiscal 1976 Federal spending, when viewed realistically, is unlikely to be held, under the most draconian restraints, much under $340 billion. The restraints would require both the agreement and the active, but unlikely, support of the Congress. Consequently, it will be necessary for the President to offer a "shock" budget, for example, $320 billion, to enable the battle of the budget to be joined on the Administration's terms. In fact, we can find ways of tieing various tax cuts to budget outlay reductions. Obviously, I do not expect the Congress, at least immediately, to fully accept our budgetary tourniquet but a broad combination of short-term and long-term proposals, spelling out for the American people both the alternatives and the problems, gives us a fighting chance to win this battle.

(5) In reality we are going to experience a very large budget deficit in fiscal 1976 which, excluding the fiscal aspects of our energy proposals, is likely to exceed $30 billion.

The President inherited both the existing tax structure and the current set of expenditure programs. He can, and should, argue that the deficit and present fiscal arrangements are intolerable. He should stipulate that they cannot be sanctioned, and accordingly propose on an emergency basis immediate major reductions in expenditure programs, coupled with the carrot of tax cuts.

(6) The energy options which will be shortly offered to the President will create some modest revenue surplus which will have to be folded into any particular tax proposals. Once the key decisions on energy, Federal expenditures and the acceptable budget deficit are made, appropriate tax options can be developed relatively quickly for Presidential decision-making.

(7) Both the energy and budgetary messages contain the potential for the exercise of dramatic leadership to wrench the economy from its path of deterioration. It will also be important to add additional highly visible special "zing" proposals to alert the public that our usual way of doing things in this country has got to change. These special programs should not be constructed however until the broad thrust of the economic policy of the President has been determined.

In Conclusion

In the months ahead the Congress and the American people are going to have to make a watershed decision. They will have to decide whether to continue on the path of ever increasing control of the American economy and society by government,or to turn back and stop the progression towards a welfare state and the regimentation that that implies.

Freedom has been our heritage. This is the type of societal arrangement which made our nation great. But unless some very major changes are instituted in our emerging national priorities we will certainly find that we will have backed into a crisis-ridden regimented society, dominated by conflicting pressure groups. The result will be the deterioration of the social structure that is already becoming so sadly evident in the United Kingdom. The further we move in that direction, the more difficult it will be to restore our traditional way of life.

Our economy has been the envy of the rest of the world. We must restore the productive power and vitality of our free enterprise system. Our bicentennial should be a period of celebration over current successes as well as joy in this nation's great historical achievements.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

November 26, 1974

MEMORANDUM FOR THE PRESIDENT

Subject: Current State of the Economy

Although recent developments have not altered our basic outlook for the economy during 1975 they have caused our estimates of economic conditions during the first half of next year to slip toward the bottom end of the range of possibilities that appeared plausible earlier.

The economy is now in the midst of a marked contraction in production, employment and incomes. Recent developments have centered in the automobile industry, where the drop in sales has been more sudden and more substantial than expected. The decline in sales is causing layoffs and cutbacks in production, which must be expected to continue through the first quarter of next year. The contraction is not restricted to automobiles. The easing of the shortage situation has caused a slippage in the demand for inventories since August and more recently the coal strike is also having an impact, but one which cannot yet be easily evaluated.

Real GNP should be expected to decline in both the current quarter and in the first quarter of next year. We must expect this to be reflected in pronounced increases in unemployment over the next few months. The evidence points to a significant increase for November (This will be announced during the first week of December.) The employment reductions now being announced in the automobile industry will not be fully reflected until early in January when the December rate is published. The weakness that we anticipate in the economy during the first half of next year is consistent with rates of unemployment in the 7 to 7 1/2 percent area.

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The decline in output is expected to end during the first half of next year -- although this will depend upon the speed and extent of the recovery in automobile sales from the present abnormally depressed levels of October and November. Prospects are reasonably good for a turnaround in housing reflecting the further improvement in mortgage financing that we anticipate. Capital goods are holding up quite well, but business investment has been subjected to a number of adverse forces that make developments in this sector questionable for late 1975 and 1976.

While we expect a bottoming during the first half of next year, we cannot rule out the possibility of a more extended slide. In any event, it is difficult to envision an economy that would be strong enough in the second half of 1975 to reduce the rate of unemployment.

Alan Greenspan
Chairman

Remarks by Alan Greenspan

Chairman of the Council of Economic Advisers

Before The National Economists Club

December 2, 1974

"Economic Policy Problems for 1975"

The economy is slipping rather perceptibly at present. Layoffs have begun to proliferate and the unemployment rate is rising markedly.

The softening economy apparently is beginning to have a substantial impact on the rate of inflation as is now becoming evident both in the published statistics and also in evidence of mounting price discounts and other related developments. Although it is difficult at this stage to project the first quarter of 1975, it now appears probable that the rate of inflation will recede to 7 or 8 percent by the early spring. At the same time, of course, unemployment rates are moving up and are likely to reach and probably exceed 7 percent during the next six months.

I often hear it argued that because we are making progress on the inflation side and, more importantly, because the economy is slipping, the emphasis of economic policy should be shifted from fighting inflation to fighting recession.

I believe this is a false alternative. The economic circumstances of today are not those of the late 1950's and early 1960's when one could view policy in terms of such simple alternatives. Inflation and recession are not unrelated but instead reflect differing aspects of the same economic malaise. To fail to recognize and confront the problem is to perpetuate the ever worsening policy alternatives which now confront us.

Economic policy is usually directed at the achievement of several competing objectives with priorities which shift in response to economic circumstances. Conventional macro-economic policy has generally been based upon the existence of a set of options which presuppose stable and reversible underlying economic relationships. Either implicitly or explicitly the policy response functions are based upon the presumption of a stable Phillips curve tradeoff. During periods of economic slack and resource availability it is presumed that an expansionary fiscal or monetary policy leads of necessity to an increase in production and employment. Conversely, a restrictive policy is presumed to lead to reduced demand and ultimately to reduced production. Moreover, it is implicit in this context that the division of any given increase in nominal dollar demand between changes in physical volume and changes in the price level is relatively constant through time. What was not anticipated, however, was that the frequent exercise of overly ambitious stop-go policies biased towards expansion would cause the Phillips Curve to shift, producing increasingly high rates of inflation at any given level of unemployment. As so often happens in economics, what appears both possible and desirable in the short-run may turn out to be unsustainable and undesirable in the long-run. The evidence both for the United States and for other countries around the world suggests that the Phillips Curve has, in fact, been moving to the right in recent years so that any given low level of unemployment or slack in the economy implies a rising rate of inflation through time. The shift in the unemployment-inflation tradeoff has been so pronounced as to make the very existence of such a relationship open to serious question. And this raises some very fundamental questions for macroeconomic policy.

One possible explanation for the shift in the underlying relationship in recent years involves the problem of measurement -- perhaps the statistics do not represent what they are believed to represent. Demographic shifts in the composition of the labor force have obviously caused an increase in the measured unemployment rate that is consistent with any level of excess demand in the labor markets. Not only has frictional unemployment increased as the turnover of labor rose because of composition effects but the losses to the unemployed may have fallen as well. For instance, the level of hardship imposed by any particular unemployment rate has been falling, partly because of the rapidly rising proportion of the unemployed who qualify for and receive tax free unemployment benefits in almost all age and sex cohorts of the experienced labor force. Moreover, the average worker has a higher level of liquid assets relative to income and greater access to borrowed funds and to welfare benefits during spells of unemployment than was the case in years past. There are also a number of significant private unemployment benefit programs such as those in the automobile industry which reduce, if not eliminate, the hardship of being unemployed. Nor should we overlook the fact that the standard family today contains more jobholders than formerly and this may also have reduced the instability of family income.

These factors tend to cushion the effects of unemployment on the jobless and thereby enable the average unemployed worker to spend more time in job search. The worker is less apt to be forced to take the first job that becomes available and this tends to make the asking wage less responsive to cyclical forces. As a consequence, the measured unemployment rate would be increasingly upward biased over time as an indicator either of labor market slack or of hardship. This bias is difficult to measure statistically. In any event, it probably does not explain more than a small part of the observed shift in the Phillips Curve over a period of years. Over short periods, of course, the marginal income loss from involuntary unemployment is still bound to rise with the rise in the level of the unemployment rate, though perhaps not as much as, say, a decade ago.

It seems to me that most of the explanation for the shift in the relationship is the result of inflation and the additional uncertainty associated with the change in expectations of the future trend of the price level. In fact, I would go further and argue that at some point inflation itself, through expectational factors and a complex set of risk premiums, becomes a depressant on economic activity which alters the shape of the policy response mechanism that is presumed by traditional contra-cyclical economic policy measures.

One major element of uncertainty that confronts the average household is the expectation of inflation. Inflation introduces uncertainty regarding the future cost of maintaining or improving one's standard of living. Consumers would be expected to react to an expectation of a higher price for a specific commodity by accelerating their purchase of the commodity to the extent that it can be stored at low cost. However, as a technical matter, consumer investment opportunities in nonperishable items other than those traditionally defined as consumer durables are quite limited. Moreover, there is greater uncertainty over specific price movements than about average consumer price level changes. This calls for a general purchasing power reserve rather than hedge buying a few storable commodities.[1/]

In fact, most econometric work indicates that the physical volume of purchases varies inversely with price change, probably because consumers find that increased money holdings are the most desirable hedge against uncertainties. Consumer surveys also suggest that the average household reaction to expected rises in the general price level is retrenchment rather than an increase in purchases. One reason is that every household is confronted with projected budget costs for some fixed amounts of food, utilities, and housing services. Apprehension that prices on all of these relatively fixed budget items will rise in the future will cause consumers to cut back on current purchases of discretionary items in order to create reserves to help meet potential increases in their cost. In principle one would expect that households would also project a rise in incomes as a result of expected price increases, but the certainty equivalent of any such expected augmentation of household wages is probably far less than the rise in income that will actually occur on average.

Another motive for savings stems from the uncertain cost of purchases that are intended in the future -- such as the cost

1/ Hedge buying becomes a dominant force only during hyperinflation when consumers rush to convert rapidly depreciating currency into any storable commodity in the hope of preserving the purchasing power of assets. This however is not a rush to consume.

of contingencies, the expected costs of maintaining a standard of living in old age, providing for the education of children etc. Expected inflation lifts the costs of these future purchases and prompts consumers to increase current savings in order to maintain the real value of savings in terms of future purchases of goods and services. In fact, the most recent survey by the Survey Research Center of the University of Michigan indicates that only 13 percent of consumers queried suggested that inflation caused them to buy in advance. More than one-half (54 percent) indicated that they cut spending as a reaction to inflation and most of the remaining responses indicated that purchases tended to be restricted more to necessities and this is the equivalent of a cut in discretionary spending.

When <u>expectations</u> of rising prices are being built into the household decision-making process, we expect to see a rise in the <u>ex</u> <u>ante</u> savings function or a fall in the propensity to consume. It is important to recognize that this is related to the expectation of future inflationary increases and not to current or previous price increases, except insofar as these enter into expectations. Or more exactly, a rise in the uncertainty premium associated with future price change expectations induces elements of fear and retrenchment in consumer behavior. One is also correct in presuming that these inflation expectations would bear some relation to recent historical price changes. Current consumer buying patterns in the United States are consistent with this general hypothesis. Witness, for instance, the drastic reduction in automobile purchases that far exceeds the normal response to a rise in car and gas prices alone.

A similar set of conditions affect private business investment decisions, only the pattern is more complex. The immediate effect of an expected rise in the price of a product is to raise the discounted cash flow rate of return for potential investors in new facilities. As a consequence, if the basic cost of capital or so-called "cut-off rate of return" does not change, the arithmetic of corporate project analysis will create an immediate sharp increase in the number of profitable capital projects. The initial response to an increase in inflationary expectations would thus seem to be an increase in the physical volume of plant and equipment appropriations similar to our experience of 1973 and the first three quarters of this year. Eventually, however, the expectation of inflation will also become embodied in the inflation premium charged by lenders and hence in the nominal rate of interest and in the cost of equity capital. Because inflation expectations would eventually cause symmetrical results with respect to both the rates of return and the cost of capital it would appear that capital expenditures in real terms would, as a first approximation, be invariant to the expected rate of inflation. However, an acceleration in expected inflation rates also produces an increase in the variability of price and cost expectations and hence an increase in the risk premium associated with those changes. Such risk premiums are additional to the usual risk associated with any investment project and increase the required target or cut-off rate of return. Consequently, real capital expenditures after complete adjustment will be below the level associated with lower rates of inflation. Although this process may be just beginning in the United States, it is already fairly far advanced in the rest of the world, especially in those countries where inflation has become endemic following periods of price stability.

Thus I believe it is clear that an increase in inflation expectations tends to increase risk premiums and reduce real effective demand both for consumer goods and for capital goods.

To the extent that expansion biased policies create inflation and gradually induce a corresponding rise in inflationary expectations, there will be a tendency for the Phillips Curve trade-off to deteriorate. This is equivalent to saying that a progressively decreasing proportion of any rise in nominal GNP is converted into increases in real GNP. Rephrased in policy terms: progressively more expansionary policies are required to sustain any given low level of unemployment. At the extreme of such a progression is the case in which expansionary policies are no longer capable of reducing the unemployment rate.

However, implicit in a neutral policy stance or even a fixed package of expansionary policies is a presumption of declining real effective demand. Eventually, as slack opens up, there will be a decline in inflationary pressures, slippage in inflation expectations, a reduction in risk premiums associated with such expectations, and finally a recovery of real effective demand. In short, if expansionary policies do not become progressively accelerating the initial rise in inflation-based risk premiums eventually comes to an end and is reversed.

Unfortunately, the process of risk premium deflation has been aborted in the early stages of adjustment in recent years. Ratchet effects have thus been set up which have led to a progressively smaller share of nominal GNP increases being translated into gains in real GNP. As a consequence, ever larger inflation risk premiums have been engendered.

Once risk premiums generated by variable rates of inflation become a major part of private decision-making processes, their expurgation is not a simple task. For it is clear that reduced real incomes, which are associated with persistently growing rates of inflation and the early stages of their decline, create a wholly new set of uncertainties and risk premiums. These are associated with rising concern with job security in the household sector and growing uncertainty in the business sector engendered by declining corporate profits and uncertainties with respect to future expected earnings trends. In the absence of any shifts in policy, we would expect that the period of declining risk premiums associated with gradually declining rates of inflation would be accompanied by rising risk premiums associated with declining levels of real income. These may be different types of uncertainties but their effects are the same on the household and business decision-making processes. Moreover, there is an obvious danger that the real income decline can become cumulative, as rising risks accelerate the downside pressures on economic activity.

Thus once the inflation genie has been let out of the bottle it is a very tricky policy problem to find the particular calibration and timing that would be appropriate to stem the acceleration in risk premiums created by falling incomes without prematurely aborting the decline in the inflation-generated risk premiums. This is clearly not an easy policy path to traverse but it is the path which we must follow. In principle, considering the usual lags in economic impact from policy changes, one should eschew expansionary policies until the benefits from declines in inflation based risk premiums no longer exceed the cost of rising risk premiums created by weakening economic activity. Since the benefits may be longer in coming, but also more lasting, than the costs, this is, of course, no easy calculus.

This is the reason why we have always viewed the current stagflation as not a simple fight against inflation or fight against recession. Rather it presents the more fundamental problem of our balancing policies to bring the sum of two types of risk premiums back to the manageable proportions of earlier years. I realize that there are many who believe that the sensitive policy balancing act can somehow be made substantially easier by returning to so-called incomes policies. In our view this approach is illusory and merely attempts to mask and delay the underlying adjustment that is required.

A neutral policy, if followed until the economy has restabilized, is one way to proceed recognizing, of course, that the automatic counter-cyclical stabilizers are operating. Our judgement is that we are currently on the declining portion of the inflationary risk premium curve. But until the economy stabilizes the increase in the future income/layoff risk premium can conceivably more than offset the reduction in the inflation risk premium. The question is whether the increase in the income/layoff risk premium can be intercepted by a change in policy that would prevent a rise in the sum of both risk premiums. The danger is, of course, that any effort to do so, unless cautious, would be interpreted as abandonment of the anti-inflation effort for some time. If so, this could set into motion a system of inflationary expectation patterns that would provide another step-up in the Phillips Curve. It is essential that we do not throw away the gains that we are in the process of making in reducing the inflationary risk premiums by hasty policy actions.

Having sketched out the broad problems currently confronting macro-economic policy, I should like to now explore the usefulness of the various policy instruments in confronting the type of problem we now have.

First of all with the possible exclusion of unemployment insurance, I would rule out any attempt to use Federal expenditures as a counter-cyclical policy tool. Pressures continue to mushroom under the vast numbers of programs which are continuously being created. The resulting uptrend in outlays is very difficult to suppress. In addition to the expansion of existing programs, new programs regularly devour the large fiscal dividends which are invariably promised three to five years out, but never seem to materialize. The normal workings of our government, both the Executive and the Legislative, create a whole set of new programs every year just as a result of normal government procedures. One cannot say beforehand precisely what bills will be passed during the year nor at what cost, but recent history suggests a large unspecified uncontrollable which is strictly a function of the fact that our government meets and functions in creating new programs and initiatives virtually all year long.

Federal transfer payments in constant dollars have been increasing at more than twice the rate of total real GNP. This has been financed in recent years by sharp declines in real defense expenditures -- an area of the budget from which very little more can be taken. As a consequence, unless this trend slows down, we will either be looking at huge deficits with strong inflationary pressures or sharply rising tax rates required to finance the juggernaut of Federal outlays. In my view, the most Draconian measures applied to Federal expenditure growth are still likely to leave the rate of increase at too expansionary a level. If we are to prevent our expenditure acceleration from getting out of control, and there are those who think it already is, we cannot think in terms of expenditure stimulus, as a short-term expansionary tool for economic activity. As I indicated earlier, the senstitive counter-cyclical unemployment insurance payments or similar counter-cyclical measures with self-correcting elements in them are quite different from the vast proportion of government outlays. Budget expenditure policy should be focused only on long-term considerations.

To the extent that the economic circumstances of early 1975 make fiscal measures appropriate, we should focus our attention wholely on the tax side of the budget. Rapid and timely action to reduce taxes is more feasible than expanding Federal programs. Moreover, there is a far greater possibility of being able to reverse the action in the future should circumstances warrant it, although the evidence here is rather mixed.

Monetary policy, of course, is a very sensitive and flexible counter-cyclical tool. There is very little I can add to the current discussion on monetary policy and even if I could, I shouldn't. I have avoided complicating this discussion by bringing in the obviously related considerations of micro-economic policy and the vast subject of energy policy.

I have tried this evening to outline some of the theoretical considerations which underlie our philosophy of policy and the types of macro policy instruments which we believe are appropriate for the problems confronting us. I have assiduously attempted to be as vague as possible on specific policy measures for fear of being interpreted as announcing some significant change in this Administration's policy. The Council of Economic Advisers doesn't make policy. The President makes policy.

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

File

May 8, 1975

MEMORANDUM FOR THE PRESIDENT

Subject: April Wholesale Price Index

Summary

The Wholesale Price Index increased by 1.5 percent in April, reversing a 4-month decline. Prices increased sharply for farm products and processed foods and feeds (4.8 percent). More recent evidence suggest the possibility that declines in farm prices can be expected in next month's WPI release. The increase in the industrial commodity index was small (0.1 percent) and although unchanged from the previous month, reflects a nearly continuous decline in the rate of inflation in this sector in the last nine months. The increase in the industrial commodity index was dominated by the increase for fuels and power.

Alan Greenspan

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

Detail

Although the all commodity WPI increased by 1.5 percent in April, the annualized rate of increase from January to April has been 0.6 percent, substantially below the 12.7 percent increase since last April.

The April WPI increase is attributable to a sharp increase in the prices of farm products and processed foods and feeds. The monthly increases of 4.8 percent reversed four months of declines ranging from 2.2 to 3.7 percent. Whereas both components decreased in the four previous months, the indexes for farm products and for processed foods and feeds both increased in April, by 6.7 percent and 3.5 percent, respectively.

The seasonally adjusted rate of increase in the industrial commodity WPI was 0.1 percent. The rate of increase in the index had declined sharply since the 2.9 percent rate of increase in July 1974.

Fuels and related products and power showed a substantial increase in April (1.1 percent). Although the index declined in February, it increased (0.6) percent in March. The prices for most items in this category are lagged and refer to a month or two earlier than the index month. The index may,therefore, be reflecting some of the impact of the February increase in oil import taxes.

Wholesale prices of consumer finished goods, which have a major but lagged impact on commodity prices in the CPI, increased at a seasonally adjusted monthly rate of 1.3 percent, after declining in the 2 previous months. The increase was largest for foodstuffs (2.6 percent), smaller for nondurables excluding food (0.3 percent), and unchanged for durables.

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

January 28, 1976

MEMORANDUM FOR THE PRESIDENT

Subject: Monthly Report on Monetary and Credit Conditions

Revisions of money-stock data

The Federal Reserve has just released revised money stock data back to 1973; revisions going back to 1959 should be available shortly. The effects of these revisions on 1975 data are quite small. The level and growth rates of M_1 and M_2 were not affected very much. The largest changes were in the first half of 1975, where the rate of growth of M_2 was reduced by 9/10ths of a percent, that of M_1 by 1/2 percent. In both cases these revisions were largely due to revisions in the seasonal factors for the second quarter.

Recent behavior of interest rates and monetary aggregates

During the past six months the growth in M_1 and M_2 has slowed noticeably compared with the 12 months before (See the Chart at the end). From mid-July 1975 to mid-January 1976 M_1 grew by 2.4 percent, M_2 by 6.0. In the 12 months preceding, that is, from July 1974 to July 1975, both M_1 and M_2 grew 2.3 percentage points faster -- 4.7 and 8.3 percent respectively -- despite the fact that this earlier period overlapped the worst stages of the 1974-75 recession.

The slow rates of growth during the last six months are below the lower limits on the Federal Reserve's ranges of tolerance for monetary growth rates: 5 percent for M_1,

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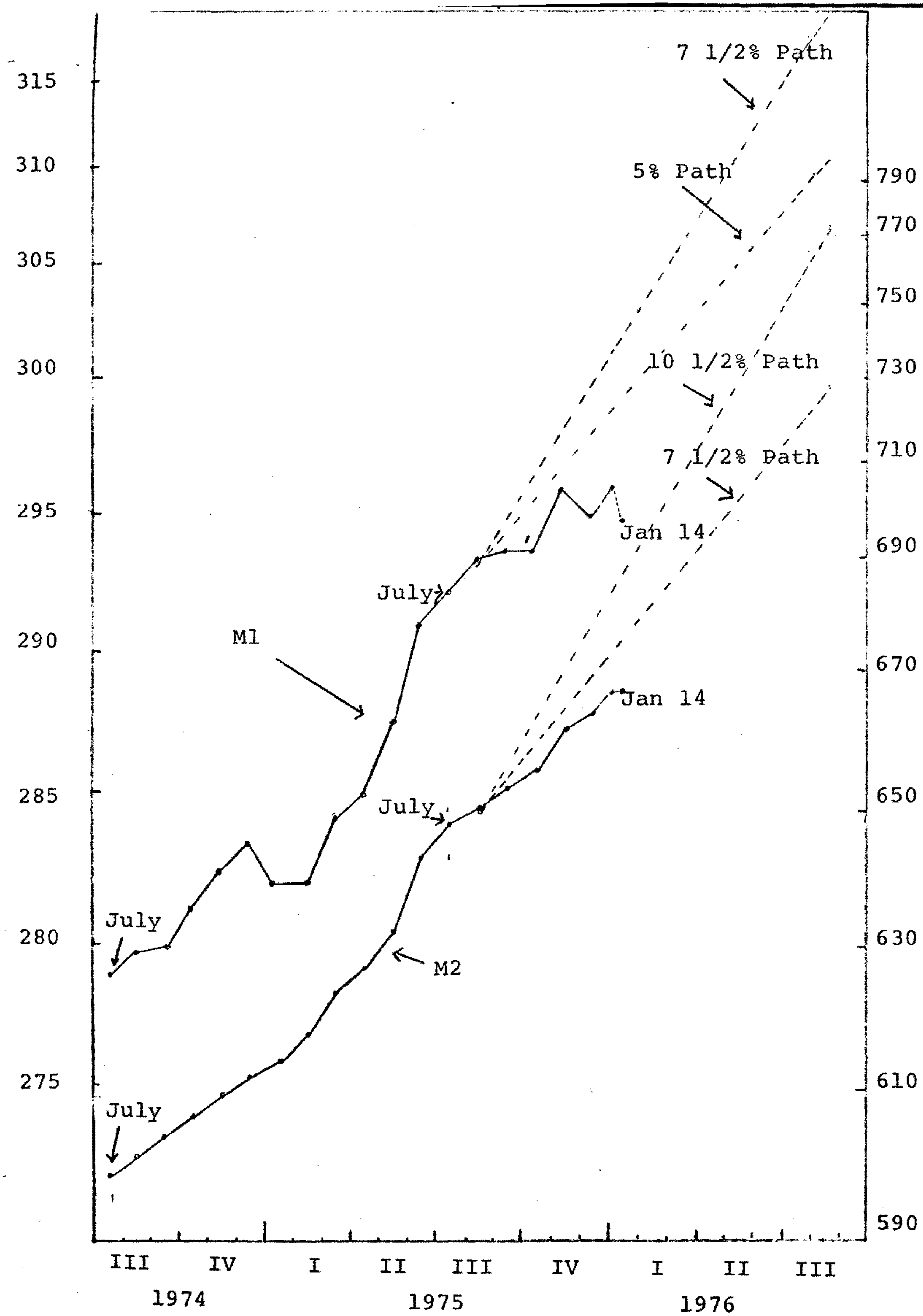
7-1/2 percent for M_2. They have persisted now for six months. And they are the only example in the postwar period of a slowdown in monetary growth at this stage of a recovery. At the same stage of each previous postwar recovery growth in M_1 and M_2 has speeded up rather than slowed down. It is possible that technological changes in the financial system have fundamentally changed the relationship between money and economic activity. There is some evidence of such change but it is very tentative. Thus, many economists, both monetarist and non-monetarist, have expressed the fear that if these slow rates of monetary growth continue they could jeopardize the recovery.

Short term interest rates fell relatively sharply in the first two weeks of January continuing the slide that had begun in early October. By mid-January both the rate on 4-6 month price commercial paper rate and the Federal funds rate were below their 1975 lows. Long-term rates have also fallen considerably over the same period. One possible explanation for the drop in rates, especially long rates, is that inflationary expectations may well have been reduced and the increased confidence of market participants could have reduced risk premiums. This explanation would be consistent with the sharp rise in the stock market during January. The continued sagging of interest rates remains something of a puzzle, however, since in every previous postwar recovery except the one beginning in 1970 interest rates have begun a sustained upward movement no later than two quarters after the recovery has begun.

Burton Malkiel

Burton G. Malkiel



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COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

February 17, 1976

ALAN GREENSPAN, CHAIRMAN
PAUL W. MacAVOY
BURTON G. MALKIEL

MEMORANDUM FOR THE PRESIDENT

Subject: Monthly Report on Economic Conditions

The most notable economic news in January was the decline in the unemployment rate to 7.8 percent from 8.3 percent in December. The decline was a result of an increase of 800,000 in employment, as measured by the household survey, which more than offset a 400,000 increase in the labor force. The changes in employment from month to month are affected by sampling error and seasonal factors as well as underlying trends, however, and thus the magnitude of the increase in employment may be overstated. Consistent with this view is the fact that employment as measured by the establishment survey increased by 360,000 persons in January. Even if this lesser increase is a more accurate reflection of employment it reinforces the view that the economy is continuing to grow and the unemployment rate is continuing to fall. While the unemployment rate is not expected to register another sharp decline in February and could even move higher temporarily there is little doubt that the unemployment rate for the first quarter of 1976 will be significantly lower than the average for the fourth quarter of 1975.

Coupled with the strong increase in employment in January, industrial production rose 0.7 percent. This increase coming after a strong 0.9 percent increase in December indicates real economic growth in the first quarter could be substantial.

There was also good news with respect to prices in January. The wholesale price index showed no change, seasonally adjusted, in January. We have now had three consecutive months of almost no change in wholesale prices. However, within the wholesale price index for January a 0.4 percent increase in industrial commodities was offset by a 1.8 percent decline in prices of farm products and processed foods and feeds. Since futures prices of agricultural products have begun to rise, in part as a result of dry weather in wheat producing areas, farm product prices are not expected to continue to decline. Moreover, the most recent survey of purchasing agents revealed some heating up in the underlying industrial price structure. Nonetheless, the moderate rate of increase in industrial prices in the current report is encouraging. Because of the favorable pattern of wholesale prices, consumer prices should show only moderate increases for January.

Housing remains an area of concern. Total housing starts declined in November and December (data for January will be available on February 18). Building permits issued have shown almost no growth since July. The stock of unsold houses remains a drag on the housing market as does continuing high mortgage interest rates. Other areas of some concern are business spending for plant and equipment and retail sales. Investment spending for plant and equipment typically does not increase until a recovery is firmly underway and that pattern has been repeated in this recovery. The lag in the recovery of investment spending may be longer in this recovery since the recession was more severe than previous ones and hence capacity utilization rates reached very low levels. An upturn in business investment spending is usually preceded by an upturn in new orders for nondefense capital goods. These orders have not shown any substantial improvement since July. However, the financial position of firms improved dramatically in the last half of 1975 and if demand and output continue to grow as we expect an upturn in new orders can be expected. Retail sales were disappointing in January as they declined by 0.3 percent. This followed a strong December increase of 2.8 percent, however. Whether the poor showing in January merely reflects random or seasonal patterns or something more substantial remains to be seen and the February figures will be watched closely.

The narrowly defined money supply (M_1), which consists of currency and demand deposits, increased in January only 1.2 percent at an annual rate. Part of the slow growth in M_1 may be due to technical factors that encourage a shift of funds from demand to time accounts. A broader measure of the money supply M_2, which includes time deposits, increased at an annual rate of 10 percent in January which is both within the Fed's target range and sufficient to support the recovery. Interest rates generally drifted lower in January. The 3-month Treasury Bill rate reached 4.96 percent in January down from 5.50 percent in December. Longer term interest also declined. For example, Moody's AAA Corporate Bond rate declined from 8.79 percent in December to 8.60 in January. Stock prices rebounded sharply in January and Standard and Poor's index of 500 common stocks was 33 percent above its level a year earlier.

Burton Malkiel

Burton G. Malkiel
Member

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ǂR. GREGORY NOKES

ǂAssociated Press Writer

WASHINGTON (AP) - President Ford's top economic adviser said today that a midyear review has prompted the administration to stick with its original forecast for 1976, including that of continued high unemployment, despite the nation's ''sustained and durable'' recovery from recession.

Chairman Alan Greenspan of the President's Council of Economic Advisers said that the nation should not expect the large gains in economic output of the last nine months to continue at such a high level.

And despite substantial improvements in recent weeks, he said the administration still believes the jobless rate may be 7 per cent or more at the end of the year.

''As of mid-year ... there did not appear to be compelling reasons to make major changes in the over-all outlook for 1976,'' Greenspan told the Joint Economic Committee.

However, Greenspan said the rate of inflation probably would be slightly better than the 5.9 per cent increase forecast by the council last January.

And the increase in the nation's Gross National Product likely would be somewhat greater than the council's earlier forecast of a 6.2 per cent gain, he said.

Although he did not mention specific forecasts for the year, he said the nation's underlying rate of inflation probably has been reduced to a range of 5 to 6 per cent.

Greenspan said the gains in employment and the drop in unemployment, from the recession's high of 8.9 per cent to 7.3 per cent last month, have been dramatic. Even so, he offered no change in the earlier official forecast of a jobless rate of from 7 per cent to 7.5 per cent at the end of 1976.

While the economy may not match the gains of past nine months, when over-all economic output increased at an annual rate of 8.4 per cent, Greenspan said most evidence points to a sustained and durable recovery in the year ahead.

''Consequently, although the pace of the recovery should be expected to subside a bit, there is no evidence that it will fade in the immediate or foreseeable future,'' he told the committee.

He said the low rate of inflation, averaging about 3.5 per cent during the past four months, probably cannot be sustained because food prices should begin increasing slightly again after declining during the first part of this year.

He said the nation needs to exercise restraint in its money and spending policies in order to keep the economic recovery from igniting inflation again.

''Unless we can accomplish this we cannot safely count on a continued deceleration in inflation. Indeed we cannot even count on being able to avoid another serious future recession,'' he added.

ǂInflation: 6th graf a4340.

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COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

July 20, 1976

MEMORANDUM FOR RONALD NESSEN

Subject: Second Quarter GNP

Real Gross National Product is estimated to have increased at an annual rate of 4.4 percent in the second quarter of 1976 down from an upwardly revised 9.2 percent real rate of growth in the first quarter. The annual inflation rate in the second quarter as measured by the change in the GNP deflator was 4.7 percent.

Quarterly quotations of the growth rate of real GNP frequently show a ragged pattern. This is largely because quarterly changes tend to be dominated by swings in inventory behavior. For example, during the third quarter of 1975 real GNP grew at a 11.4 percent annual rate as the massive inventory liquidation of the second quarter of 1975 ended. During the fourth quarter of 1975, unaided by a swing in inventory behavior, the growth rate fell to 3.3 percent. In the first quarter of 1976 the growth rate swelled to 9.2 percent as a swing to moderate inventory accumulation accounted for about half of the increase in real GNP. During the second quarter of 1976, however, inventory behavior did not support the growth in GNP.

Quarterly growth rates may also vary because of statistical errors in measuring components of GNP. It is possible that the rate of growth of GNP in the second quarter of 1976 may have understated the strength in the economy. Other data such as the growth in industrial production would be consistent with a somewhat larger GNP growth rate during the second quarter.

The second quarter GNP figures and other sources of data do, however, signal some moderation in the rise of output. Such pauses are typical of economic rebounds and are helpful in avoiding imbalances and in prolonging the expansion. All our evidence suggest an acceleration of growth, above the second quarter rate, during the last six months of the year.

Burt

Burton G. Malkiel

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
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July 20, 1976

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AMERICAN REVOLUTION BICENTENNIAL 1776-1976

Burt
Burton G. Malkiel

COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

July 22, 1976

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

MEMORANDUM FOR THE PRESIDENT

Subject: Monthly Report on Economic Conditions

Real Gross National Product is estimated to have increased at an annual rate of 4.4 percent in the second quarter of 1976 down from an upwardly revised 9.2 percent rate of growth in the first quarter.

Quarterly quotations of the growth rate of real GNP frequently show a ragged pattern. This is largely because quarterly changes tend to be dominated by swings in inventory behavior. In the first quarter of 1976 real GNP grew at a 9.2 percent annual rate as a swing from inventory liquidation to moderate inventory accumulation accounted for more than half of the increase in real GNP. In the second quarter of 1976, however, inventory behavior did not support the growth in GNP.

Quarterly growth rates may also vary because of statistical errors in measuring components of GNP. It is possible that the rate of growth of GNP in the second quarter of 1976 may have understated the strength in the economy. Other data such as the growth in industrial production would be consistent with a somewhat larger GNP growth rate during the second quarter. The 6.8 percent average of the first two quarters better represents the progress of the economy over the first half.

The second quarter GNP figures and other sources of data do, however, signal some moderation in the rise of output. Such pauses are typical of economic rebounds and are helpful in avoiding imbalances and in prolonging the expansion. Despite this moderation in output growth, real final sales rose at a 4.7 percent annual rate -- virtually identical with the pace of the preceding four quarters -- indicating that a solid recovery continued in the quarter.

While retail sales were weak in April and May they rebounded sharply in June rising 2.7 percent. Still

AMERICAN REVOLUTION BICENTENNIAL 1776-1976

consumer spending has been restrained and savings rates are relatively high. Businessmen have also been quite cautious as inventory to sales ratios have been declining and new orders for nondefense capital goods are just now showing signs of considerable strength. Housing starts, though slightly slower than we had expected, have been moving up slowly and are currently around the 1-1/2 million mark. All our evidence suggests an acceleration of growth, above the second quarter rate, during the last six months of the year.

Price developments in the second quarter were quite consistent with our view that the underlying inflation rate in the economy has been cut to a 5-1/2 to 6 percent annual rate. The GNP deflator rose at a 4.7 percent annual rate in the second quarter compared with a 3.2 percent rate in the first quarter. The CPI increased at a 6.1 percent annual rate during the second quarter compared with a 2.9 percent rate during the first quarter. During the first quarter both food and energy prices declined while there were considerable increases in food and especially energy prices in the second quarter.

The inflation rate for all other items in the CPI exclusive of food and energy actually decelerated from the first to the second quarter. Prices of all other items in the CPI increased at an annual rate of 7.7 percent during the first quarter but only at a 5.5 percent rate during the second quarter. The rate of increase in services prices less gas and electricity declined from an 11.1 percent annual rate during the first quarter to a 5.3 percent annual rate during the second quarter. Thus, in the nonfood, nonfuel area there appears to have been some progress in the second quarter. Moreover, despite the high settlement for the electrical workers, increases in compensation per hour during the year have not exceeded our January forecast. The wholesale price index increased 0.4 percent from May to June only slightly up from the 0.3 percent increase in May and down from a 0.8 percent increase registered in April. Preliminary indications are for continued moderation in wholesale prices in July, which improves the outlook for some easing of inflationary pressures at the consumer level in the months ahead.

The unemployment rate rose to 7.5 percent in June from 7.3 percent in May. The slowdown in real GNP growth may account for a lack of progress in reducing unemployment in June. Nevertheless, faulty seasonal adjustment procedures are largely, if not wholly responsible for the rising rate in June. We cannot be certain if the May rate was too low or if the June rate was too high. It is possible, however, that these seasonal adjustment problems will impart an upward bias to the unemployment rate in July.

During June the narrowly-defined money stock (M1) declined and the growth in the broad money stock (M2) slowed appreciably as the Fed intervened to offset the bulge in the aggregates which occurred in May. Nevertheless, the second-quarter growth rates for both aggregates were above the upper limit of the Federal Reserve's tolerance range.

Short-term interest rates inched down in the latter part of June as the market came to anticipate that the Fed would eventually ease off on the credit reins. Indications in the first week in July that the Fed had indeed lowered its Federal funds rate target pressed short-term rates even lower. However, data released last week showed that the aggregates jumped significantly during the first week of July. Despite the fact that part of the jump may be due to faulty seasonal factors, the market interpreted it to mean that further tightening was in store, and short-term rates rose.

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COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

September 3, 1976

MEMORANDUM FOR THE PRESIDENT

Subject: Monthly Report on Economic Conditions

Summary

The limited data now available on the early part of the third quarter indicate continued relatively slow growth in aggregate economic activity. However, behind the pause that is currently taking place we see a fundamental improvement in economic conditions, and expect the last half of the quarter will show renewed strength. We, as well as the majority of forecasters, are projecting strong growth of over 5 percent in real terms in the next 4 quarters.

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machinery industries, indicative of a broadly based strong rise of investment in the next four quarters. This is confirmed by the just released Conference Board data on new capital appropriations by manufacturers in the second quarter, which rose 13.2 percent, and by the value of plant and equipment projects started by manufacturers last quarter, which rose 9.6 percent. Strong increases in business fixed investment over the coming quarters seems assured. Thus, there is no reason to doubt the underlying durability of the recovery.

The wholesale price index declined 0.1 percent in August, following a small 0.3 percent rise in July. The industrial commodities index rose 0.7 percent in both months, following a 0.5 percent rise in June. These three consecutive months of relatively large price increases, averaging 7.8 percent annual rate, are disturbing. We also experienced a brief burst of large increases last fall. At that time however, a variety of product prices were recovering from depressed lows reached during the inventory liquidation of early 1975. In both cases large rises of petroleum prices contributed significantly to the magnitude of the rise of industrials. The current problem lies in the fact that the 5-3/4 percent (a.r.) rise of industrials apart from petroleum in the last 3 months is acceptably low in itself, but when averaged with the 11 percent (a.r.) rise of petroleum prices yields an unacceptably high total. Increases in petroleum prices may moderate over the balance of the year, however. Consumer prices in July rose 0.5 percent and at an annual rate of 6.3 percent over the 3 months ending in July.

We continue to believe the basic inflation rate is in the 5 to 6 percent range and will remain there for the rest of the year. Food prices are not expected to rise sharply and hourly wages are rising at less than 7 percent through August. Since fringe benefits have been rising more rapidly, total compensation of labor per hour has been rising at about 8 percent (a.r.). The healthy output gains expected with an investment boom and acceleration of personal consumption this fall will bring productivity increases of 2 to 3 percent (a.r.).

Over the summer the unemployment rate has increased to 7.9 percent of the labor force. The increase in the unemployment rate is not the result of any shortfall in job creation. Indeed one-half million new workers have been added to payrolls during the past two months, a very large figure. The reason for the increase in the unemployment rate is an unprecedented increase in the number of people, especially women, entering the labor force. Though hard to confirm, some part of the extraordinary increase in the labor force may reflect the fact that a number

Analysis

Industrial production increased only 0.2 percent in July. Though most major sectors showed little change or small increases, the July index was depressed by increased strike activity, especially in coal mining. The value of manufacturers' shipments in July was unchanged from June, as a sizable decline in motor vehicles offset increases in most other industries. The early indication on production in August from employment data suggest that output probably rose slowly, as hours worked were up 0.1 percent over July.

Retail sales in July fell 1.2 percent from their June peak to a level 0.5 percent lower than the second quarter average. Thus, even with sizable increases in August and September, this quarter will probably not show a stronger rise of consumer demand than last quarter. Weekly retail sales data for August, however, are up over 1-1/2 percent on average from July. Sales of new domestic autos increased to a very strong 9.8 million at an annual rate (a.r.) in early August, apparently spurred by promotions at GM. Since then sales have slowed to around an 8 million pace, more typical of the rate for the year as a whole. It appears that shortages of some popular models, and not of demand, has been at least partly to blame for lackluster summer sales. Overall, car inventories are rather low and there remains an imbalance of too many small cars and too few intermediate and large models in the stock.

Personal income in July rose sharply by $13.9 billion, including a large $8.1 billion increase of wages and salaries. Continued good increases should bring an acceleration in consumption through the remainder of the year.

Starts of new housing units fell sharply in July to 1.387 million (a.r.). The problem is exclusively one of multi-unit structures, which continue to be plagued by problems of profitability. July multi-unit starts of .259 million (a.r.) were less than 30 percent of the high average of 1973. By contrast, July starts of single unit houses of 1.128 (a.r.) virtually equaled their high 1973 average. Permits for new housing increased to 1.219 million (a.r.) in July, the highest since April 1974 and sufficient to assure some rebound in housing late this year.

Business investment reported in the revised second quarter GNP released in August continues to show a very strong rise in real terms of 8.4 percent (a.r.). New orders for non-defense capital goods rose 7.7 percent during the second quarter, and a remarkable 13.2 percent in July. The July rise was dominated by the fabricated metals and nonelectrical of seasonal workers remained in the labor force this summer because of their eligibility for Supplementary Unemployment Assistance. We believe that the extraordinary rise in the labor force growth is coming to an end and we expect continued strong growth in job creation will soon sharply reduce the unemployment rate.

Money and credit conditions remain favorable to sustain the economic expansion. The $800 million decline in M_1 and the relatively small $700 million rise in M_2 during the statement week ended August 25 temporarily halted any credit tightening fears which may have been caused by the large increases in these aggregates in the previous weeks. Looking at longer run averages, M_1 has been increasing at a rate below the 4.5 percent lower bound of the Federal Reserve's current tolerance range, while M_2 growth has hovered around the 9.5 percent upper bound of the tolerance. If M_1 and M_2 continue to grow at opposite ends of their respective tolerance ranges, there is little likelihood that the Fed will significantly alter its apparent Federal funds rate target of 5-1/4 percent. Consequently, other short-term interest rates will also remain near current levels.

During August the money and bond markets continued the rally that began in early July. For the week ended September 1, the average yield on U. S. Government bonds fell about 1/5 of 1 percent below the average for the week ended June 30. Rates of 3-month Treasury bills have fallen by 1/4 of 1 percent in the same period. Factors which indicate further declines are the reduced near-term borrowing needs of the Federal Government, the recent favorable inflation figures, and the continued sluggish performance of business loans at commercial banks.

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COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

ALAN GREENSPAN, CHAIRMAN
PAUL W. MACAVOY
BURTON G. MALKIEL

October 1, 1976

MEMORANDUM FOR THE PRESIDENT

Subject: Monthly Report on Economic Conditions

Summary

The projections of the Commerce Department indicate that real GNP will grow at a 4 percent annual rate in the third quarter. This compares with a 4-1/2 percent growth rate in the second quarter and a 7 percent average growth rate during the past five quarters. Despite a 1-1/2 percent decline in the index of leading indicators reported in September, signs of an acceleration of real growth appear to be at hand. Recent data suggest substantial increases in retail sales, investment spending intentions and housing activity. Unless the Ford Company strike is prolonged, the fourth quarter should show a substantial increase in the real rate of GNP growth.

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Detailed Analysis

The slower growth phase in economic activity appears to have continued at least through the early summer. Retail sales did not grow in July. Business fixed investment has yet to show substantial strength and housing starts were very low in July. Moreover, businessmen appear to have been extremely cautious in their inventory behavior during the third quarter. At the present time the Commerce Department estimates that inventory accumulation actually fell from second quarter levels.

In recent weeks, however, despite the decline in the index of leading indicators, signs of renewed acceleration in economic activity have appeared.

July retail sales estimates were revised upward by $0.6 billion to $53.8 billion. This compares with $54.0 in sales for June. Retail sales then rose sharply to $55.0 billion in August. Current evidence suggests that retail sales for September will exceed August by perhaps $0.5 billion.

Housing starts increased to 1.54 million units in August from 1.39 million units in July. Most of this increase is in multi-unit dwellings. Single unit starts continued at a very strong 1.20 million unit level. Total starts in August were the highest since February and the near-term outlook is for further strength in this area. Building permits have exceeded starts in permit-issuing areas by 206 thousand units at an annual rate for the last two months. This suggests good gains in housing starts in coming months.

Indicators of business fixed investment have been rising strongly in recent reports. Conference Board data on new capital appropriations by manufacturers rose 13.2 percent in the second quarter. The value of plant and equipment projections started by manufacturers last quarter rose 9.6 percent. New orders for nondefense capital goods have been quite volatile in July and August rising sharply in July but falling by the same amount in August, helping to push the leading indicators down. Nevertheless, the average of nondefense capital goods orders for July and August is 11-1/2 percent above the average during the year.

In August, the unemployment rate increased for the third consecutive month to 7.9 percent. As we have noted before, the rise in unemployment has been caused by an extraordinary increase in the labor force and not a shortfall in job creation. During the past two months alone the economy has produced 500,000 new jobs but the labor force increased by 850,000, including 350,000 adult women. We continue to believe that the growth in the labor force will slow in coming months and with continued increases in employment, the unemployment rate should drop sharply. The September unemployment rate from the household survey will be released on October 8.

The rate of inflation appears to have stabilized at a rate around 6 percent. The consumer price index (CPI) has risen 0.5 percent in each of the last three months despite continued moderation in food prices. This is because commodities, excluding food, have been rising at an annual rate in excess of 7 percent during the three months ending in August. This high rate of inflation has been sustained by large increases in energy prices.

The wholesale price index (WPI), which has been growing at very low rates since May, has been influenced by declines in food prices during the last two months. Food prices are expected to remain weak through the Fall and into the early part of 1977. The WPI for fuels increased at a 24 percent annual rate in August. We expect the rate of increase in energy prices to decline, however, in coming months.

The decline in long-term interest rates which began in June continued during September, but at a slower pace. The rate on corporate Aaa bonds averaged 8.37 percent during the first 4 days of this week compared with an average of 8.62 percent in June. A heavy supply of new corporate bonds may exert some upward pressure on long-term rates during October, but this will be partially offset by reduced Treasury borrowing needs brought on by lower than anticipated Federal expenditures.

Short-term interest rates stabilized during September with the Federal funds rate holding at about 5-1/4 percent, the midpoint of the 5 to 5-1/2 percent range set at the August 17 meeting of the Federal Open Market Committee. By mid-September three successive declines in weekly M_1 figures had led some market participants to expect a decline in the Federal funds rate. However, the large $4.5 billion increase in M_1 for the week ending September 15 and the subsequent $2.8 billion decline in the following week reminded participants of the volatility of the weekly figures and temporarily ended these expectations. Looking at longer run averages, neither M_1 nor M_2 appear to be growing at rates sufficiently different from the Federal Reserve tolerance ranges to require a significant change in the Federal funds rate. Commercial and industrial loans at commercial banks were unchanged from July to August and still show no significant sign of recovery. In the latter part of September several large banks announced a reduction in their prime rate from 7 to 6-3/4 percent, but this reduction has not yet spread to a majority of commercial banks.