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Comments on the Economy

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The economic recovery and expansion is strong. Although this recovery got off to a slow start, it has now made up the lost ground. Output has increased about as much during the first two years of this expansion as during previous expansions. Most important, output is accelerating.

Each new revision of the statistics on real output, productivity, industrial production or other main line indicators of economic expansion shows that the rate of increase is faster than previously believed.

Civilian employment is now rising considerably faster than in the months following the 1964 tax cut, a period that most businessmen look back on and recall pleasantly. Employment in 1964-65 rose about 2-1/2% annually. Currently employment is rising at 3-1/2% annually. Inventories are rising, borrowing is rising, and present indications are that capital expansion in 1973 will be at a very much higher level than in 1972. Generally, the forecasts of capital spending during periods of expansion underestimate the rate of increase, and I believe that the error will be repeated this time.

The inflation front poses a somewhat less rosy picture. If we compare the growth rates of manufacturing wages and compensation per man hour with rates of change of productivity, we get approximately 2-1/5% minimum rate of inflation required to close the gap without cutting profits. I believe, therefore, that 2-1/2% is the minimum rate of inflation that we can expect next year. With current strong demand in the economy, and a very expansive monetary policy, the rate of inflation will probably increase next year. I look for an average rate of expansion of the money stock of about 8%. With such a rate of increase and the deficit in the $25 to $30 billion range, I believe we can expect real income to grow about 6% and prices to rise by
about 4%. If these forecasts are approximately right, interest rates on long-term corporate bonds will rise by no more than a quarter of a point. The prime rate will reach above 6%, and if there is no political interference it will get to 6-1/2%.

There will be no credit crunch, unless the Federal Reserve precipitately slows the money supply growth rate in a new effort to stop inflation. I do not expect any such effort to occur.

What could go wrong with the optimistic forecast? I see five major problems in 1973. Any one of these problems is capable of making the forecast look foolish.

First, there is the size of the deficit. This is a much talked of problem. The fact is we simply don't know now what the deficit is going to be. In fiscal 1971, the government predicted that it would have a surplus of 1.3 billion. It actually ran a $23 billion deficit. In fiscal 1972, the year that just was completed, the initial forecast was an $11.6 billion deficit. This was latter revised to a $38 billion deficit. The actual deficit was $23 billion. One must, therefore, take as one of the great uncertainties the size of the government deficit. The deficit is important not only for its own effects, but even more because the growth rate of the money supply will be increased if the deficit is larger. In estimating the growth rate of the money supply will average 8%, I am anticipating that the federal government will do somewhat better in holding down its spending than it has in the past but will not do as well as the more optimistic members of the administration would like to do. I have left the deficit in the $25 to $30 billion range.
Second, the method of financing the deficit is at least as important as the size of the deficit, probably more important. A reacceleration of monetary growth to the 8% rate is assumed. Any attempt to keep short-term interest rates from rising will require much greater increase in the money supply than I have anticipated. There is lots of room for being pessimistic about the future here.

Third, you may recall Regulation Q. Regulation Q ceilings on interest rates were removed from large certificates of deposit in 1970, but they continue to be applicable to small deposits. If market rates rise substantially above Regulation Q ceilings, there will again be large shifts out of thrift institutions into commercial banks and into other markets. These disruptive movements and the likely government response -- new controls -- pose a threat to the stability of the economy of 1973.

Fourth, I expect controls to remain during 1973, although the precise form of controls may change. The Congress is unlikely to refuse to give the President renewed authority to control prices and wages, and the President is likely to ask for renewed authority. Consequently, wage and profit controls are almost certain to remain in some form. As a result of controls, particularly profit guidelines, there will be some limitations on profits, probably increased borrowing with resulting pressure on interest rates, spending on less productive projects than might otherwise have occurred, more travel, more advertising and other expenditures that will increase costs and hold down profits.

Fifth, many people fear strikes and wage negotiations. I am less concerned about this problem than the ones listed above. I cannot
believe that there will be major strikes of long duration during 1973. The reason is that most contracts now contain cost of living escalator clauses and workers have recovered most of the losses that they experienced during the early years of the inflation.