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The Economy at Mid-Winter 1972

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Last November, I expressed concern about four major uncertainties overhanging the economy and the stock market. Most of them are still with us, at least in part.

(1) The international position of the dollar and the type of international agreement negotiated.

Part of these negotiations have been completed and have given the U.S. a reduction in costs of selling abroad ranging from 16% in Japan to zero in Canada. The average gain, weighted according to exports, is only 4%. The small gain is due to the very sizeable trade with Canada, and the Canadian decision to continue floating their dollar.

The rest of the agreement -- tariffs, quotas, etc. -- remains to be negotiated at the time of writing. A likely result is that the U.S. will trade-off some reduction in import duties on chemicals for increased exports of farm products and increased opportunities for investment.

We have already agreed to apply the investment credit on purchases of foreign machinery, a major concession.

(2) The rate of monetary growth.

From July to November, the money stock remained virtually unchanged. There are now signs of an increase in the rate of monetary expansion.

Several factors suggest to me that the problem during 1972 will not be that the money-supply doesn't grow enough but that it grows too much. If this proves to be correct, the rate of inflation will increase in 1972 even more than the current forecasts of about 3 or 3-1/2%.
My reasons for believing that we are likely to have a very high rate of monetary expansion in 1972 is that the government has:

(i) a large deficit in 1972 fiscal year;

(ii) a smaller but still sizeable deficit in fiscal 1973 beginning next July;

(iii) a large amount of short-term debt in the hands of foreigners; at least part of this debt will have to be refunded by sales to foreigners;

(iv) the rather sizeable inventory accumulation that will have to be financed if we are to have a strong recovery in 1972.

All of the above factors will contribute to raise interest rates. The Federal Reserve will permit some increase, then it will attempt to keep interest rates from rising by increasing money.

(3) The recovery in corporate profits.

Without a sizeable recovery in profits, there will be a weak recovery in the economy. The price and wage boards are more likely to control prices than wages, holding back a profit recovery, generating uncertainty and causing a waste of management time.

Forecasts for profits, after-tax profits, vary all over the lot -- from 12% to 27%. The latter seems out of line. If GNP increases by $85 to $90 billion, I expect an increase of 15% in after-tax corporate profits. A 15% increase would mean about $52 to $53 billion.

A very large increase in the money-supply this quarter would make me want to reconsider this forecast.
(4) The rate of inventory accumulation.

There is still no sign of any large inventory accumulation. I take this as a sign that many businessmen remain skeptical about the chance of having a $100 billion recovery this year.

The consensus forecast calls for an $8 to $10 billion increase in inventories. The figure is obtained by a mechanical rule and seems to me to be too large.

I expect the money-supply growth and the very large deficit to maintain a good expansion. I don't see the very strong first quarter expected by those who forecast a 6-1/2% increase in real output. The very optimistic forecasts of $100 billion or larger increase in GNP seem too optimistic on the basis of what is occurring. If we get $100 billion it will be because of more inflation than the 3 to 3-1/2% rate commonly forecast.

The recession affecting most European countries probably means that the U.S. balance of payments will not improve as much in early 1972 as might have been hoped. The smaller the improvement, the smaller the sell-off of the very large holdings of U.S. securities now held by foreigners, the smaller the rise in U.S. interest rates and in the growth rate of money.

Federal Reserve policy and the outlook for corporate profits remain the major uncertainties.