Memorandum: IDS Projections for 1972-1973

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Mr. H. Don Gordon  
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Dear Don:

I'm responding to your request for an evaluation of the IDS projections for 1972 and 1973.

Projecting a year or more ahead is made difficult by the number of uncertainties and often differences between forecasts reflecting differences in assumption. At present, as so often in the past, a principle problem is to forecast government fiscal and monetary policy. IDS does not report a final decision on the fiscal 1973 budget and does not mention the fiscal 1974 budget. They hope monetary policy will become less inflationary and mention a 5% rate of growth as a target.

I believe the fiscal 1973 budget deficit will be above $30 billion. Also, I believe the administration will try to cut the fiscal 1974 budget that is presented next January, (I mentioned both of these assumptions in May). Nevertheless, I do not see enough budget cutting to prevent a very large deficit for fiscal 1974.

The deficit has to be financed. If we assume, a 6-7% average rate of monetary growth, instead of the 5% in IDS, we get the Federal Reserve to purchase about $6 billion of the deficit each year. That leaves $25 billion to be sold to the public. To get that much debt into the hands of the public, interest rates must rise.

The main problem with the IDS forecast comes at this point. Rising interest rates can pull up the velocity of money. The IDS forecast of 5% monetary growth in 1973 and 9% increase in GNP requires a 4% increase in velocity. This is too large. Velocity increased at a trend rate of 3-1/2% until 1966 or 1967. The increase has been 1-1/2% a year for the last few years. To get a 4% increase, either velocity must rise much more than in the past few years or the money stock must grow more than 5%. I believe the latter is correct.
If money grows at 6 to 7% and the government runs deficits of the size I suggest, the minimum rate of inflation is 3-1/2%. I believe the rate of inflation will increase in 1972 and 1973. How much the rate increases depends on actual policies.

For 1972, IDS comes out about where I came out at the May meeting. In fact, I'm a bit more optimistic. (10% gain at annual rates for the next three quarters with the rate of inflation between 4% - 4-1/2% and real output 5-1/2% - 6%).

We differ on the following matters.

(1) I have food prices increasing in the fall and winter at a faster rate.

(2) I don't expect a monetary agreement or a monetary crisis this year (despite the current problems of the pound).

(3) I expect interest rates to rise for reasons I laid out in detail last month.

(4) I expect price controls to remain in effect. Expenditures for advertising, R&D, etc. should increase to keep reported profits from rising to the ceiling in some firms. Companies will make relatively unproductive expenditures before rolling back price increases. (This is important only where prices have increased).

Two uncertainties that have not been mentioned:

(1) McGovern's nomination. The election of McGovern, or any chances of his election, will have an important effect on business confidence. McGovern's programs are more extreme than the programs of many European Socialists. (Brandt, Wilson).

(2) Labor troubles. 1973 is a year of contract renewal at GE, Westinghouse, auto workers. If controls are still on, will there be a nasty showdown between the unions and the government?

Best regards. I look forward to seeing you in August.

Sincerely,

Allan H. Meltzer

AHM:jep