Economic and Financial Outlook

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My remarks at our August meeting focussed on three main areas of interest, the outlook for the economy, for financial markets and for profits and controls. In this report I summarize my views on each of these areas.

The Economy

Early this year, in February-March, I projected a strong economy with output growing at approximately 5-1/2% for the year and an inflation in the range of 4-1/4% to 4-1/2%. Recent devaluations of the dollar in the exchange markets, particularly in May and June, forces an increase in the rate of inflation. The reason is that the decline of the value of the dollar will raise the cost of imports. My general outlook for the year, however, remains about as before.

Also, I continue to believe that the rate of real growth in 1974 will be in the 3 - 4% range with inflation 4 to 4-1/2% if the money growth rate remains no larger than 6% for 1973 and 1974. At the present time, the rate of monetary expansion for the year is somewhat higher than 6%, but there is reason to hope that the rate of expansion will taper off a bit during the latter part of the year. If the rate of monetary expansion does not taper off in the latter part of the year, inflation will be somewhat greater in 1974 than previously projected.
My main errors so far this year have been in forecasting profits and the stock market. I projected a rate of profit increase of 15%, much lower than the rate that has occurred so far this year. However, there is reason to believe that the rate of profit growth will slow in the second half of the year, substantially, so that the forecast will not look as bad six months from now as it does at the present time. The forecast of the stock market has been wrong and I see no reason why the stock market should advance substantially from the level at which it has remained during the last five to six months.

At this writing, the odds remain against recession. Whether or not there will be a recession depends very much on what happens at financial markets during the next several months. Of particular importance is what happens to the rate of growth of the money stock. A sharp contraction, from the present 7% average rate of monetary expansion to 4% maintained for six months would produce a mild recession. Without substantial monetary contraction, I have difficulty in seeing the case for recession. This is no change from my comments in May.

A strong force in the economy is the current position of the dollar. The sharp devaluation against other currencies, particularly the mark and the Swiss franc strengthens our competitive position in the world. This strengthens demand for our exports.
The Financial Markets

There are three principal factors affecting the financial markets at the present time. One is the Fed policy that I discussed just a moment ago. Second is the current high demand for borrowing. The third is the effect of the current balance of payments position and the U.S. exchange rate. Interest rates have risen very sharply in the last few weeks, as everyone knows. The reason for the rise is the very strong demand for borrowing mainly from the private sector. This borrowing has not been accompanied by any substantial change in the ratio of inventory to sales, so further additional borrowing can be expected if the economy continues to expand and inventories continue to rise relative to sales. In addition, there has been a substantial increase in the demand for real capital -- plant and equipment -- and this further increases the demand for borrowing and market interest rates.

I do not believe that the peak in interest rates has come. Since my visit, there have been some slight declines in market rates. I do not believe that these are the start of a reversal in the present trend. Rather, economic factors suggest that interest rates will continue to rise at least for a month and probably for a longer period.

How long? No definitive answer to that question can be given. We don't know the shape of Federal Reserve policy in the fall. The rate of monetary expansion has not slowed any if at all during the last several months. If the rate of monetary expansion were to slow, interest rates would go considerably
higher before they declined. My guess is that the Federal Reserve will hesitate to cause another credit market crunch. This will keep interest rates from rising as high as they would if there were a crunch, but it will maintain the real growth rate of the money supply and the rate of inflation that I am projecting for 1974.

A third main factor operating on interest rates at the present time is the balance of payments. The U.S. is now a much more open economy than it was five or even three years ago. International flows are very large. There has been, as I expected when I talked to you, a substantial reflow of short-term capital to the United States. This reflow has affected commodity markets, interest rates and other financial markets. This flow provides an amount of lending in U.S. financial markets to offset some of the high demand for borrowing. Hence it is a factor moderating the rise in interest rates. It is not sufficient by itself, to prevent a further increase in market rates in my judgment. However, a continuation of the flow at current high rates will help by supplying some funds to match the very large demand for borrowing.

The short-term behavior of interest rates depends, mainly on these three factors. If the demand for borrowing continues to expand at about the rate that it has over the past several months, if there is no substantial reduction in the growth rate of the money supply, and if foreign lenders continue to supply funds to the U.S. market in large amounts, the movement of interest rates will be moderately upward for the next thirty to ninety days.
Profits and Controls

Current high interest rates are an important factor in preventing a rise in stock market prices. At present rates, foreign holders and others can obtain historically good returns on short-term capital while preserving their options. I expect that many will choose to do this. The fact that we now have profit controls under Phase IV, and these controls are difficult to interpret at present, moves portfolio holders in the same direction as interest rates -- into fixed coupon securities. Consequently, it is hard to see the makings of a substantial rise in stock prices from current to present levels.