3-1973

Where Are We?

Allan H. Meltzer
Carnegie Mellon University, am05@andrew.cmu.edu

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There are two main subjects of current discussion. The first is whether there will be a recession in 1974. The second is the current position of the dollar. My talk at our most recent meeting covered both of these subjects, but I would like to extend some of my remarks.

Will there be a recession?

This seems almost a strange question. The economy is moving forward with an enormous momentum. The current expansion is one of the strongest expansions we have experienced in the post war period. Every day brings new information about further expansion in the economy and further pressure on the shrinking excess capacity.

The first quarter is clearly very strong. How is it, then, that there is so much gloom and pessimism about? As I indicated at our meeting and continue to believe, the current balance of payments problem helps to finance the US budget deficit for 1973. Given the financing of the deficit, there is less chance that the Federal Reserve will have to finance the deficit by printing new money. Hence, the chance of an extremely large increase in the money supply is reduced.

Market participants, newsletters and collected sages talk about a boom-bust cycle. They seem to see the Fed expanding the money supply too much during the early part of 1973, then coming down with a real crunch toward the end of 1973 throwing the economy into a tailspin and bringing on the recession of 1974.
This scenario cannot be ruled out, but it is not by any means the most likely scenario.

I believe there will be a reduction in the rate of growth of the money supply this year from the 8-1/4% achieved last year to the 6% that I predicted last fall. If that projection is correct, and there is absolutely no way of now forecasting with any accuracy whether or not it will be correct, there will be at most a slight retardation in the economy in 1974. The retardation in the economy will not be recession. The economy will move close to full employment and will be pressing against capacity. Consequently, there will be less room for real expansion, and the rate of real expansion will drop from the approximately 6% expected for this year to something below 4%. There would still be expansion.

How much of a drop in the money supply would be required to bring the economy into recession? Economic forecasting is not so precise that we can put a point estimate on the size of the reduction in the growth rate of the money stock required to bring on a recession, but I would begin to worry if the money supply growth rate were to slow below 4%. A drop from 8.2% last year to a maintained 4% for two quarters of this year would be enough to bring on a more severe retardation. A mild recession -- of the 1966 variety -- might then become a more likely possibility.

The important thing to recognize is that there is now no sign that such a recession is imminent nor is there any sign of a reduction in the money supply growth rate. There is a slight retardation in the money supply growth rate, mainly due to technical factors, and unlikely to be maintained over the next couple of weeks. My current guess is that the first quarter growth rate of the money supply will be closer to 7-1/2 or 8% than to 4%.
Consequently, I remain more concerned about the prospect that we will fail to hold the rate of inflation to the 4 - 4-1/4\% range than that we will have a recession. And, I remain concerned that there will be pressure on the short end of the money market because many Regulation Q ceilings remain in effect.

Renewed monetary problems:

I can think of no good reasons for the renewed outbreak of speculation against the dollar, and I do not see any reason for it to persist. I recognize that those are strong statements in a period of monetary uncertainty, but I feel that the current problems are the result of open mouth policy by various central bankers.

I see no real possibility that there will be a lasting agreement between the members of the Common Market to maintain a common float. I believe that the British pound will turn much lower before the end of the year and that the longer term factors favor the dollar if we are able to keep our rate of inflation below the rate of inflation in Western Europe.

Consequently I see very little change in the underlying monetary factors from those I described when I was with you a week or so ago. The balance of payments will remain in deficit, but the dollar will retain much of its past importance if our inflation is held to present levels.

The Stock Market

Four principal uncertainties overhang the stock market. Two are described above. One is the rate of monetary expansion and the future rate of inflation or the possibility of recession. A second is the experience of the dollar in recent weeks. The third is a matter that I talked about at
some length during our meeting. There is now a struggle over the size of the Federal government and the ability of the administration to control the budget. If the President is able to gain control of the budget, the prospects for less inflationary expansion in 1974-75 improve. The market has difficulty evaluating who is going to win that fight, and this adds to the uncertainty currently overhanging the market.

The fourth main item of concern is a matter more closely related to the pricing of securities. The current Phase III controls are highly ambiguous. The dividend restriction on companies, particularly cyclical companies, forces those companies to reduce their rate of dividend payment below the rate they would pay out of current profits. Hence these stocks become less attractive. More money flows into stocks with high price earnings ratios. The reason is that the current dividend restrictions force companies to retain a large fraction of their earnings and to invest more than might be desirable in plant and equipment or in the shares of other companies. This is also a reason for the current very high rate of capital expansion. By requiring companies to retain earnings, companies with high variability and low expected rates of return -- shown by low price settings ratios -- are forced to invest in assets that have low average expected rates of return. Hence investors prefer to buy stocks of non-dividend paying companies with high expected rates of return. This pushes the price earnings ratios on these stocks higher.

Removal of Phase III controls on dividends, or loosening of the rule about dividend payments, would I believe do a lot to change the present situation. I continue to believe that the capital stocks will improve relatively and absolutely, but removal of dividend restrictions would be especially helpful.