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U.S. FARM AND FOOD POLICY: WORLD VIEW

ECONOMIC OUTLOOK

(By Courtenay Slater, Chief Economist for the Department of Commerce)

Good morning. I am pleased to be here to participate in the National Food and Agricultural Outlook Conference. In the last few years, the importance of the agricultural sector in the overall economic outlook has been repeatedly—and at times dramatically—demonstrated. So I will be following the discussions at this Conference with great interest. In my remarks, however, I will stay away from agriculture and attempt to survey the other major aspects of our economic situation and prospects.

Several recent policy actions will have important effects on next year's economic performance: A major tax reduction has just been signed into law, a comprehensive anti-inflation program has been adopted, and a set of monetary and financial moves designed to strengthen the international position of the dollar has been undertaken.

These moves have led to a great flurry of reassessments of next year's outlook. Some of these assessments have been highly pessimistic—I believe unduly so. Thus I would like to begin this morning by attempting to put recent developments into perspective. Despite our undeniably serious inflationary problem, the economy is just finishing up a year of well-balanced real growth. Employment has grown rapidly and unemployment has been reduced. The most recent data indicate that the pace of economic growth is being sustained in the fourth quarter.

Somewhat slower growth is to be expected next year, but there are sufficient sources of strength and there is sufficiently good balance among the major economic sectors that it is difficult to envisage an abrupt or dramatic slowing of economic activity. Thus 1979 may be looked to as a year in which growth will moderate, perhaps bringing with it some rise in unemployment, but a year in which progress will be made in narrowing our foreign trade deficit and reducing the rate of price increase.

Let me back up and review 1978 in a little more detail. During the first 9 months of this year real output grew at an annual rate of nearly 4 percent. Employment grew by nearly 2½ million persons and the unemployment rate declined by two-thirds of a percentage point, from 6.6 percent in the fourth quarter of last year to 6 percent in the third quarter of this year, and 5.8 percent in October. Nearly 59 percent of the adult population, a record proportion, now hold jobs.

The pattern of recent economic growth has been well balanced. Home construction has continued at very high levels and business construction has begun to pick up. Exports have been growing rapidly and import growth has moderated, so that the merchandise trade deficit in the third quarter was roughly one-third less than the very large first quarter deficit. Consumer spending has held up well, and inventories have been held carefully in line with sales performance. Plant capacity utilization has been rising, but remains well below the range which might threaten to create shortages or bottlenecks.

In short, the economy is basically healthy, and the country is more prosperous today than it was a year ago, and inestimably more so than at the bottom of the recession, when unemployment rates reached 9 percent and the inflation rate topped 12 percent. There is every reason to expect economic health and prosperity to be sustained next year.

Let me briefly review the prospects for the major economic sectors. Consumer purchases should continue to rise at moderate rates, although well below the 5 percent annual rate of gain during the first 2 years of economic recovery. Concern has been expressed that the consumer is overextended financially—that the level of debt repayments relative to income is so high that consumers must retrench. I would agree that, if the economy needed a superstrong consumer sector to serve as its driving force, or leading sector, then some concern over prospects for economic growth would be well justified. But, in contrast to earlier stages of the recovery, there are other sectors ready to take the lead.

Furthermore, the consumer is in better shape than may at first appear. Though debt obligations are high relative to income, the consumer has been able to meet payments promptly. Delinquency rates on consumer loans are no higher now than in 1976. The high debt repayment to income ratio probably in part reflects the greater use of credit by a younger and rapidly expanding labor force. Next year, continued gains in employment and earnings will provide support to the consumer sector, and the personal tax reduction which takes effect in January will allow a somewhat larger share of earnings to remain in the consumer's hands.

Residential construction activity is expected to decline somewhat during the next year, due to the tightening of financial markets that has occurred during the past year. The real story here though is that the downturn in home building has held off as long as it has and that, despite the recent further increase in short-term interest rates, this downturn still is expected to be of only moderate proportions. There is a lot of underlying strength in the housing market. Vacancy rates for multifamily dwellings are quite low by historical standards, the inventory of unsold new homes is moderate, and the number of persons in the 25 to 34 home-buying age bracket is expected to continue to rise rapidly during the next couple of years. Home ownership is recognized as a good investment. Young families are willing to work hard and to incur heavy initial obligations to make this investment. This adds up to a continuing strong demand for housing, which, if financial conditions permit, will be met by a continued high rate of construction activity.

Business investment spending may be expected to add strength to the economy. New orders for capital goods have been rising strongly. Contracts for commercial and industrial construction are presently running 22 percent above year-earlier levels, in real volume terms.

Business inventories are not high relative to sales; if anything, they are a little low. The typical first stage of a recession is an unintended buildup of inventories when sales drop below expectations. This was the pattern which precipitated the sudden drop in economic activity at the end of 1974. Throughout the recovery period from that 1974 experience, inventories have been carefully controlled. There is no excess to be worked off. This is an important reason why I said earlier that it is difficult to envisage any abrupt slowing of economic activity.

The foreign trade balance is expected to improve in 1979. While the trade deficit will not be eliminated quickly, significant progress will be made. This change will stem from the more moderate economic growth in the United States, which will slow our growth of imports, as well as the decline in the value of the dollar against other major currencies, which will work to boost the level of U.S. exports and to shift some demand within the United States from imports to domestic production. The improvement already is apparent in recent monthly trade statistics. Exports of manufactured goods rose 30 percent from the fourth quarter of last year through this September, and trade in manufactures was nearly in balance in August and September, following a substantial deficit in the first half of the year. The improving trade picture will provide an important boost to domestic production and employment.

Summing up, economic growth can be expected to continue throughout 1979, although probably at a rate slightly below the potential growth of the economy. The expected growth rate for next year is not sufficient to guarantee any further reduction in the rate of unemployment. The unemployment rate is currently just under 6 percent. Depending on the exact pace of labor force growth and productivity change, next year's expected output growth could bring with it anything from a small drop to a moderate increase in the rate of unemployment.

I would like to turn now to the most critical of the problems which must be successfully addressed if the relatively sanguine forecast I have presented is to come to pass. During the first 9 months of this year inflation proceeded at an annual rate of over 8 percent. An inflation rate this high is a serious economic problem, and one which, as I am sure you realize, policymakers are taking very seriously. There are no quick, easy, or simple solutions. But important actions are being taken and we expect some progress to be made in reducing inflation.

First, a few words about the causes of our persistent inflation. Part of it is a food price problem, but I have promised you I won't talk about that, since you will be hearing other, far more knowledgeable speakers on that subject. The drop in the foreign exchange value of the dollar is another source of inflationary pressure. Not only have import prices been rising, but higher import prices allow scope for increases in prices of competing domestic products, like autos, TV sets, and steel.

Even more basic than either of these factors, however, is the rate of increase in production costs in the nonfarm domestic economy. Gains in labor productivity are a crucial factor in holding down the rate of increase in unit labor costs. However, the large growth in employment relative to output this year has meant only minimal gains in productivity. Despite improved productivity performance in the third quarter, gains from the year-earlier period were less than 1 percent, and unit labor costs were 8½ percent above year-earlier levels.

Thus the inflationary pressures in our economy are widespread, and a broad set of policies is necessary to deal with them. Both the Government and the private sector must be involved. Let me speak first of the steps the Government is taking.

The suggestion which most often is made to me concerning what the Government should do to control inflation is "cut spending"; "balance the budget." In fact, rather dramatic steps in this direction already are occurring.

There seems to be an impression in some quarters that only the Federal Reserve is moving with any resolve to deal with inflation. It is true that the Federal Reserve has raised interest rates very sharply during the past year in an effort to "lean against" the higher rate of inflation. But fiscal policy also has been moving toward greater restraint on the economy. The original tax cut proposal in the January budget called for a $25 billion reduction in calendar 1979. This has now been reduced to about $19 billion. Federal budget outlays during fiscal 1978 were $451 billion, falling $12½ billion below estimates released in January. Estimates of the fiscal 1979 deficit have been reduced by one-third, from $60.5 billion estimated last January to less than $40 billion as presently estimated. The 1980 budget is being designed to exercise continuing spending restraint and to reduce outlays as a percent of GNP.

Another helpful way of examining the economic impact of Government is to look at the combined Federal, State, and local budget. Viewed this way, the combined Government budget has been very nearly in balance during the past 6 months, with a Federal deficit which was much lower than in the previous 6 months and which was just about offset by a surplus at the State and local level.

Moving on from the budget to other aspects of anti-inflation policy, a second—and very vital—part of the Government's effort to reduce inflation deals with Government regulations imposed on the private sector. The President has directed that a Regulatory Council be established to review new and existing regulations issued by the executive branch to be sure that their economic consequences have been carefully examined. This process is intended to force the regulatory agencies—the Occupational Safety and Health Administration (OSHA) the Environmental Protection Agency (EPA), the Federal Drug Administration (FDA), and all others—to examine alternatives more fully and to choose the least costly approach to meeting a regulatory objective.

In addition the Regulatory Council will work to reduce economic regulations. The lower fares and greater service choices now available to those traveling by air illustrate what can happen when regulators seek to encourage rather than hinder competition. Similar changes in attitude and practice are needed in other regulated industries, such as trucking. It will take time before the results of these aspects of the program can have a measurable impact on the inflation rate, but the long-term results can be of great importance.

For the private sector the President has established wage and price standards, and has indicated various measures the Government could take if the standards are breeched. Annual increases in wages and private fringe benefits are to be no more than 7 percent annually.

There are, of course, some exemptions such as those for workers earning less than $4 per hour or for cases in which higher wages are offset by changes in work rules designed to produce demonstrable increases in productivity. Every effort will be made to insure that people are treated equitably. However, success of the program requires that there be few exceptions.

Business firms are expected, in general to keep price increases in the coming year to one-half percent below their average increase during during 1976–77.

The President is prepared to take action to encourage compliance with these standards. Existing restrictions on imports may be modified if domestically competing firms do not exhibit price and wage behavior consistent with the guidelines. In addition, firms either selling to the Government or selling to export markets with Eximbank assistance will be required to certify that they are within the guidelines. These steps are needed to insure that compliance with the program is widespread. General compliance will lead to a lower overall inflation rate without causing inequities among groups or individuals.

Many of you in this audience are Federal employees, and thus need no reminder that limitations have been imposed on your own pay increases as part of the anti-inflation effort. Equity will best be served if similar restraint can be achieved in the private sector.

Perhaps even more compelling than equity—as important as that is—is the stark recognition that the continued health of our economy—and to some extent of the world economy—will be influenced by the success of this program. With a reasonably successful program, the inflation rate can be held to 6½ percent or less next year. Without such success, forces could well be set in motion which would produce a serious recession next year or in 1980.

I hope I have managed to convey the importance of making this program succeed. Public support is the key to that success. All of us have a role to play in building that support. Thank you for the opportunity to discuss this vital policy issue with you this morning.