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GENERAL ECONOMIC OUTLOOK 1973

Talk by Marina Whitman
Council of Economic Advisers
at the 1973 National Agricultural Outlook Conference
Washington, D. C., 9:00 a.m., Tuesday, February 20, 1973

Once each year, in its annual Economic Report, the Council of Economic Advisers makes a forecast for the U.S. economy for the year just beginning. For those used to Delphic oracles or current authors, a forecast for 12 months ahead may not seem very venturesome, but it is fraught with pitfalls nonetheless. One of the problems of short-term forecasting, as opposed to prognostications about the 2000, is that the forecaster is likely to be still around when people can check the forecast against the reality. For 1972, we need make no apologies--the CEA forecast came closer to the mark than any of the numerous private forecasts. (1971 was a different story, but there's no need to dig up ancient history.) Since our statutory responsibility under the Employment Act of 1946 will not permit us to quit while we're ahead, let me give you the flavor of the CEA's expectations for 1973.

Fundamentally, we expect in 1973 a continuation of the solid, broad-based expansion of the economy which characterized 1972, with a continuing substantial growth of production, jobs, and income and a continuing reduction of inflation and unemployment. Specifically, we are projecting a 10 percent increase in money GNP, from an estimated level of $1152 billion in 1972 to about $1267 billion in 1973. This represents a slightly greater year-over-year increase for 1973 than for 1972 but, because we expect the growth rate will slow somewhat as the economy moves closer to the zone of full potentail output later in the year, the rate of expansion from the beginning to the end of 1973 should be slightly lower than it was over the course of 1972. The year-over-year increase breaks down into a projected real growth of 6-3/4 percent and an implied increase in the GNP price deflator of 3 percent. This price projection is consistent with the Administration's goal of reducing the rate of inflation to an annual rate of 2-1/2 percent or less by the end of 1973.

The course of the economy, particularly through the first half of 1973, will be dominated by expansionary pressures already at work in 1972, and nearly all sectors of the economy are expected to rise strongly as a result. This anticipated expansion of demand and output implies that the unemployment rate, which fell from 6 percent to 5 percent over the course of 1972, can be expected to decline further, to the neighborhood of 4-1/2 percent by the end of 1973. This assumes that the rate of growth of the labor force, which increased unusually rapidly between 1965 and 1970 as the result of a number of special factors, will remain at its long-term rate of 1-3/4 percent in 1973. The drop in the unemployment rate is expected to be less this year than last primarily because, as the economy approaches its zone of full potential in the second half of the year, its rate of expansion is expected to slow somewhat. An aggregate unemployment rate of 4-1/2 percent is likely to be composed of very low unemployment rates among some groups--adult males, heads of households, married men--and of substantially higher levels among other groups--including women and, in particular, young people. The further reduction of the unemployment rates of these latter groups, both of which include a high proportion of new entrants and re-entrants into the labor force, is likely to require policies directed specifically to the solution of their particular problems.

The forecast I am giving you today is a capsule summary of the forecast which was spelled out in more detail in the Economic Report published on January 31. The projections we made at that time added up to a picture of an expanding, prosperous economy in 1973, and we see no basis for painting a different picture today. But in the five weeks that have passed since the Report was published, something peculiar has been happening in the world outside the Executive Office Building. On January 31 there was widespread agreement on the part of private economists, the press, and the public in general with the thrust of the CEA forecast. By the end of February, this general feeling of shared optimism had been overtaken by a certain amount of uncertainty and apprehension about the economy. Part of this may simply be human nature, the conviction that when the outlook seems good it's time to start worrying. But it is worth looking more specifically into what seems to be worrying people, and trying to analyze their concerns.

First of all, some concern has developed that, if things are "too good too soon," a recession is bound to follow. By recession is meant not the gradual slowdown in the rate of expansion which is desirable for stability as we approach full utilization of resources, but a more marked slowdown which pushes the economy below its potential growth rate and causes unemployment to rise. This particular fear starts with the assumption that excessive expansion will develop in the first part of 1973, with shortages of labor and capacity, excessive inventory accumulation and temporarily large fiscal stimulus. The overheating is followed, according to this scenario, by a slowdown as the fiscal stimulus disappears, the investment boom peters out and inventory accumulation is sharply reduced--all of this accentuated by the delayed effects of the Federal Reserve's efforts to check the boom.

As we look at the evidence, we at the CEA do not find sings of an overheated expansion, either underway or imminent, that would generate a recession later. We find no indications of the excessive inventory accumulation on which this argument partly depends, either in the current rates of accumulation or in the ratios of inventories to sales. New orders for producers' equipment continue very strong, suggesting that we are not near the end of the capital goods expansion. In general, the expansion appears to have the rosy glow of health rather than the flush of fever.

None of this is to deny that, as always, there are uncertainties ahead. The mastery of the business cycle remains as challenging as ever, and as we move closer to full employment the zone of successful performance of the economy narrows and the standards for judging macroeconomic policy become more demanding. But, while uncertainty remains the human condition, we do not see in the current economic situation or in probable developments the portents of boom-and-bust disaster.

Among the more substantive problems currently facing the economy the two that appear to be uppermost in people's minds are inflation and the balance of payments. They have been there all along, but certain events of recent weeks --the upsurge in certain prices, the move from Phase II to Phase III, the latest international monetary upheavel--have pushed them into the limelight. There is no question, of course, that the containment and further reduction of inflation and the improvement of our international trade and payments positions are in the forefront of the economic challenges we face in 1973. But they are challenges which we believe can be met.

When people express their worries about inflation, the litany usually goes something like this: "Since you didn't quite make your goal of getting the rate of inflation down to the range of 2 to 3 percent last year, and given the recent acceleration in the price indexes, the loosening of the controls program, the heavy wage bargaining schedule coming up in 1973, and the fact that we are getting close to full employment of resources, how can you expect to meet an even more ambitious inflation target in 1973?" Let me take the answer a piece at a time.

First of all, the overall price story is not really one story at all, but two quite different and disparate ones. The overall price indexes--both wholesale and consumer--did indeed rise at more than a 3 percent rate during 1972, and during the total period of the Economic Stabilization Program to date a little more in the case of consumer prices, significantly more in the case of wholesale prices. And they have indeed risen somewhat faster in the past month or two. But for nonfood items, the story is quite different: the average price of these items rose at a rate well below 3 percent at the consumer level, and about 3 percent at the wholesale level. For nonfood commodities (that is, excluding services), the rate of price increase to consumers averaged less than 2 percent. The consumer price index for food, on the other hand, increased almost 5 percent during 1972 and 3 percent in the latest three-month period (October-January) while at the wholesale level average prices of farm products, processed foods and feeds rose more than 14 percent during 1972 and nearly 10 percent in the most recent three-month period. Our "inflation problem" is, it turns out, more precisely described as primarily a "food price problem."

Our job, of course, is to bring the food price problem under control and prevent it from turning into a general inflation problem, which it could if continuing and accelerating increases in food prices were to trigger wage demands large enough to set off a new round of wage-price spiral. In order to keep this from happening, the Administration has taken a number of firm actions aimed at checking rising food prices in the only effective way: by increasing food supplies. These actions will not increase food supplies overnight, nor can they prevent prices that have already taken place at the wholesale farm level from working their way through to the retail counters. Food prices, in other words, are going to keep rising faster than any of us would like for several months. But as the moves to increase supplies begin to take effect, in the second half of the year, we expect food prices to stabilize substantially.

The fact that rapid increases in demand have been accompanied by large price increases for certain agricultural commodities--lumber and hides are perhaps the most conspicuous examples along with food, in particular meat--has generated some concern that, as demand continues to expand, accelerating price increases will become more generalized. But the reasoning is based on a false premise. The rapid price increases I have just mentioned took place largely because, for those particular commodites, the production cycle is a long one. This means that supply cannot increase rapidly to match increasing demand, causing prices to be bid up. For commodities where the possibility of short-run supply response is much greater--in automobiles, for example--the large increases in demand which have accompanied rising incomes have not led to any such sharp increases in prices. Furthermore, large price increases for those raw commodities with little short-run supply flexibility tend to be damped down as they move through the production process to the consumer. This happened in 1972 and, on the assumption that productivity continues to increase at a healthy rate, it should continue in 1973.

Since the producers of most things we buy do have the capacity to increase supply in response to expanding demand, and since the economy has not reached the zone of full potential output where expanding production runs up against resource limitations, there is no reason to anticipate the emergency of generalized demand-pull inflation in 1973 if sensible monetary and fiscal policy avoid the development of excess demand conditions. This is, however, a crucially important "if." It means that the expansion of money and credit must be held to a rate consistent with the gradual slowing down of the increase in GNP toward the pace commensurate with the economy's long-run growth potential. And it means that we must achieve fiscal restraint--a responsible increase in Federal Government spending to a level which does not exceed the $269 billion set forth in the President's budget for fiscal 1974. If such restraint is not maintained, and government expenditures grow to exceed the revenues that would be generated at full employment, the effect is likely to be not a choice between accelerating inflation or higher taxes but, if history is any guide, first one and then the other.

I mentioned the heavy wage bargaining calendar scheduled for 1973 as another source of apprehension. The assumption seems to be that, because a lot of people will be negotiating new contracts this year, the settlements are likely to be more inflationary than if fewer people were bargaining. The implicit reasoning is by analogy with 1970--the most recent heavy bargaining year, when settlements were indeed inflationary. While 1973 does resemble 1970 in the intensity of the bargaining calendar, it differs from it in some other crucial respects. In 1970, the unions went to the bargaining table with a period of accelerating inflation and stagnant or declining real earnings behind them. They felt that they had been had, and the pressure to catch up was intense. Furthermore, the accelerating inflation had wrenched wage relationships among workers in different industries and between unionized and nonunionized workers out of their accustomed patterns. As the 1973 negotiations approach, the rate of inflation has declined, real earnings have increased, and the traditional union-nonunion and inter-industry wage relationships have been essentially restored. We know that in Phase III, as in Phase II, some settlements (doubtless the most widely publicized ones) will be above the general wage standard, and others will be below. But the conditions I have just described offer a far more promising framework for noninflationary settlements than was the case three years ago.

Having mentioned Phase III, let me dwell on it for a moment. The notion seems to be widespread--and maybe there was something in the "atmospherics" of our announcement of the move from Phase II to Phase III which contributed to it --that this move means the United States has "given up" on controls. That is nonsense. What we have done is trade a certain amount of form for a good deal of substance. The change in form--outside of these sectors which remain under mandatory controls--is a shift away from government administration essentially to self-administration. Under Phase II, large firms and unions had to seek advance permission for price or wage increases, with approval determined by governmental judgment as to the conformity of the proposed move with the standards spelled out in the regulations of the Economic Stabilization Program. Under Phase III, the private sector is still expected to conform to the standards set forth in the regulations, which have undergone only minor modification, but people are now expected to judge conformity for themselves. They make these judgments, however, in the full knowledge that the Government has both the will and the legal authority to step in and alter or nullify actions which are not consistent with the standards of the stabilization program.

What we gained in substance, in addition to the strong actions on food supplies already described, is organized labor's return to active participation in the program. It is well known that no controls program can succeed without the cooperation of labor. At the beginning of Phase II, labor did indeed play a major role but, after the departure of the labor members from the Pay Board, their active cooperation ceased (their passive cooperation did continue, in the form of the lowest level of strike activity in nine years). Now, with their membership on the Labor-Management Advisory Committee to the Cost of Living Council, organized labor has returned to an active role in the determination of pay standards for the Economic Stabilization Program.

There is no opportunity here to go into the detailed reasoning behind the move from Phase II to Phase III. The reasons include both negative and positive considerations--negative in the sense that it was important to minimize the still low but increasing costs to the economy of Phase II, positive in the sense that the requirements for effectiveness were quite different in early 1973 than in late 1971, and the shift reflects these differences. Let me just observe that, while Phase III is an important step in the direction of ultimate return to an economy without wage-price controls, it is also a comprehensive and effective controls program which, as the President has pointed out, will be as voluntary as it can be and as mandatory as it has to be.

The second major focus of economic concern--the external position of the United States--has been even more in center stage in recent days. Given the current state of confusion and uncertainty I shall not try to analyze the immediate situation. Let me focus rather on the longer term. In that perspective, I am convinced that the groundwork is being laid for a fundamental improvement in the external position of the United States. With two devaluations in 14 months, representing a total effective devaluation of the dollar against other currencies in the range of 15 to 20 percent, we have established a more realistic exchange position for the dollar--and the ultimate benefits of this development should not be obscured by the fact that the initial impact of a devaluation on the devaluing country's trade balance is invariably perverse. The competitive benefits of this shift will be reinforced if the United States achieves in 1973, as we did in 1972, a rate of inflation well below that of any other major industrialized nation. Finally, the cyclical relationships between this country and our major trading partners which contributed so heavily to the deterioration of our trade balance in 1972--as rapid expansion at home accelerated the growth of our imports while a certain sluggishness in the growth of several of our most important customer countries restrained their demand for our exports--are virtually certain to be more advantageous in 1973.

All of this leads me to believe that the stage is set for a turnaround in our trade balance, although no one can be sure how much time will be required for it to become evident. But, once a significant turnaround is recognized, I for one believe that the effect will be cumulative, bringing with it a favorable impact on the capital accounts of our balance of payments as well, and creating conditions under which the world finally becomes convinced that in the future the relative value of the dollar is just as likely to strengthen as to weaken.

Such optimism in the face of the historical record of the past few years, and of the current state of apprehension, may strike some as a bit fanciful. But the natural tendency is to expect things to go on as they have, and economists' models tend to be very good at predicting everything except turning points. Let me tell you a brief tale by way of illustration. Back when I was starting graduate school, the world was deeply concerned, ironic as it may seem now, with the so-called "dollar gap," the worldwide shortage of dollars. At about that time, a noted British economist came out with a book in which he offered compelling arguments as to why the dollar shortage was likely to persist indefinitely. His point was, in essence, that given the enormous productive capacity of the United States, our vast technological and productive advantages, there was no way other countries could hope to earn as many dollars as they needed. It was just about the time his book was published, in 1957, that a few perceptive souls in the Balance of Payments Division of the Department of Commerce began to be concerned with the emergence of a persistent deficit in the U.S. balance of payments. What happened after that is a familiar story. The dollar gap did not last forever and neither, I am convinced, will the dollar glut.

Finally, our current preoccupations should not obscure the crucial importance of making progress on two large pieces of unfinished business. One is the matter of international monetary reform. Such reform, along the lines set forth in the U.S. proposals, is essential if we are to have a world in which payments imbalances are effectively adjusted before they reach crisis proportions and in which exchange rates can change as required by changing economic circumstances without causing international financial upheaval. Recent events have underscored the urgency of progress in the reform effort, if change is to be achieved rationally by international agreement rather than being forced on us piecemeal by events themselves. Equally important is the need for multilateral trade negotiations to reduce barriers to trade and assist the restoration of international equilibrium. For the present payments imbalances will not be rectified by monetary measures alone, and even the best international monetary system men can devise cannot operate effectively if its adjustment processes are obviated or weakened by inappropriate trade policies. And so, progress on both fronts--the trade side as well as the monetary side--is essential if the economic growth and stability we anticipate for 1973 are to be not only realized but maintained well into the future.