Proceedings of The Conference Board Economic Forum

Inflation in the United States: Causes and Consequences

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many of our contemporaries) thinks that IBM and Avon and General Electric were always here; that God placed them on earth and then people came along to run them. Every one of those companies started with an idea – and capital. Our guess is that we need about $200 million a year in areas of venture. In the period between 1958 and 1972, there were thousands of venture-capital public offerings. This, of course, is in addition to private sources of capital. A considerable amount of new technology has evolved from this investment. Currently, there is no market for such ventures. What the alternative will be is not clear, but it is an underappreciated capital need.

Now to the dividend outlook. In 1968, total interest payments on debt and corporate dividends were about equal. Dividends have since increased modestly, and interest payments have doubled in the period of time, so the shareholder has not been getting "his fair share" – another reason why he has been unhappy as far as the stock market is concerned. Ideas about the fundamental inadequacy of depreciation rates and retained earnings have more intellectual support in Congress than is assumed. Although the political heat remains on industry, there is a recognition that new basic capacity does not come from wishful thinking.

MR. WEIDENBAUM: The earlier effort to get rid of the asset depreciation range system and the investment credit seems to have been headed off. I guess you would agree.

MR. GRANT: I would agree; that is clear.

Another subject I should comment on is securities as a hedge against inflation. Actually, common stocks have a poor historical record against inflation, if you look at Europe, at Latin America, and at the United States in the 1968 to 1974 period. The positive correlation comes only if you happen to start from a low base. My guess would be, if the rate of inflation in this country should stay higher than any of our estimates for the next three or four years, common stocks would probably be a pretty good hedge, because, from the current base, you are down 70 percent and that is 2.5 times worse than the worst thing that could still happen to you. Yields on many stocks are attractive and earnings are rising. In an environment of sharp inflation, the investor – both professional and individual – becomes suspicious of accounting; he is concerned about corporate failures and chicanery (over which there is lots of current evidence) and he is conscious of higher yields elsewhere. What he prefers is "things." Either he wants real estate – which he can sit on, look at, and say "that is mine" – or he wants dividends because dividends are "for real." The corporation mails a check; you put it in the bank and buy something with it. This is the attitude that exists in Europe today.

The 1962 to 1969 period was one of excess expectations for the stock market. Every portfolio was to go up 20 percent, and corporations did not care what pension fund agreements they made with their labor unions, because if stocks could go up 20 percent, there would be no problem. It will take a while to work our way through that attitude. The stock market needs, more than anything else, a fairly flat economy – probably a recession – so that the investor will know "how far is down." Therefore anti-inflationary

Table 13: Net Purchases and Sales of Stock by Various Investor Groups
(Billions of Dollars at Annual Rates)

	1965	1966	1967	1968	1969	1970	1971	1972	1973
Net purchasers (sellers)									
Private pension funds	$ 3.1	$ 3.7	$ 4.6	$ 4.7	$ 5.4	$ 4.6	$ 8.9	$ 7.1	$ 3.6
State and local retirement funds	0.4	0.5	0.7	1.3	1.8	2.1	3.2	3.0	2.6
Life insurance companies	0.7	0.3	1.0	1.4	1.7	2.0	3.6	3.5	3.3
Other insurance companies	0.1	0.4	0.3	0.8	1.0	1.0	2.5	3.0	1.9
Mutual funds	1.3	1.0	1.9	2.5	1.7	1.2	0.4	-1.8	-2.3
Mutual savings banks	0.2	0.0	0.2	0.3	0.2	0.3	0.5	0.6	0.3
Brokers and dealers	0.3	0.1	0.4	-0.2	0.4	0.1	0.1	0.1	0.0
Foreign	-0.4	-0.3	0.7	2.1	1.6	0.7	0.8	2.3	3.0
Total	$ 5.7	$ 5.7	$ 9.8	$12.9	$13.8	$12.1	$20.1	$17.8	$12.8
Net sellers (purchasers)									
Corporations	0.3	0.9	2.3	-0.7	4.7	6.9	13.5	12.6	7.3
Households	5.4	4.8	7.5	13.7	9.0	5.2	6.6	5.2	5.5
Total	$ 5.7	$ 5.7	$ 9.8	$12.9	$13.8	$12.1	$20.1	$17.8	$12.8

Total Net Increase in Financial Assets of Selected Purchasers of Stock

	1965	1966	1967	1968	1969	1970	1971	1972	1973
Private pension funds	$ 5.5	$ 7.2	$ 6.6	$ 6.4	$ 6.3	$ 7.1	$ 7.3	$ 5.7	$ 7.7
State and local retirement funds	3.3	4.2	4.1	4.8	5.1	6.3	6.8	7.3	8.4
Life insurance companies	8.7	8.2	8.7	9.8	9.2	9.9	12.7	14.8	15.3

Table 13: (continued)

Other insurance companies	1.2	2.1	2.0	3.1	2.9	5.5	6.6	6.2	6.9
Mutual funds	2.2	2.5	1.5	3.6	2.6	1.7	0.6	-1.8	-2.2
Mutual savings banks	4.0	2.8	5.4	4.6	3.1	4.7	10.4	11.0	6.0
Total	$24.9	$27.0	$28.2	$32.3	$29.2	$35.2	$44.3	$43.1	$42.2
Total — Excluding mutual savings banks	20.9	24.2	22.8	27.7	26.1	30.5	34.0	32.1	36.2
Total — Excluding mutual funds and mutual savings banks	$18.8	$21.7	$21.3	$24.1	$23.6	$28.8	$33.4	$33.9	$38.4

Purchases of Stock as a Percent of Net New Money Available

	1965	1966	1967	1968	1969	1970	1971	1972	1973
Private pension funds	56.5%	51.4%	69.5%	73.7%	84.9%	64.1%	122.9%	124.0%	46.8%
State and local retirement funds	10.7	11.5	16.4	27.2	35.3	34.1	46.7	40.9	33.6
Life insurance companies	8.1	3.3	11.7	13.9	18.5	20.0	28.7	23.7	21.4
Other insurance companies	7.1	18.4	16.8	24.7	33.4	18.1	37.3	47.7	27.9
Mutual funds	59.1	38.4	124.2	70.3	67.3	70.1	76.3	101.7	104.6
Mutual savings banks	4.2	1.5	4.1	5.4	7.8	7.1	4.6	5.6	4.4
Total	22.9%	21.6%	30.7%	33.8%	40.5%	31.8%	43.2%	35.4%	22.9%
Total — Excluding mutual savings banks	26.5	23.8	37.0	38.6	44.3	35.6	54.9	45.7	25.9
Total — Excluding mutual funds and mutual savings banks	22.7%	22.2%	30.9%	33.8%	41.8%	33.6%	54.6%	48.6%	30.4%

Sources: Federal Reserve Board; Smith, Barney & Co. Incorporated.

policies are bullish for the market. I also suspect a decline in commodity prices to be a positive factor for stock prices (after an initial negative reaction).

The professional investor is still looking for reactivation of the old game as far as stock selection is concerned, despite the obvious new trends previously discussed. Table 13, showing net purchases and sales of stocks by various investor groups, provides a background on market psychology in the purchase and sale of securities. In 1971, private pension funds not only took 100 percent of their new money inflow, but sold bonds to invest in common stock. History shows that that was the wrong time to do this.

In 1973, that figure was down to 47 percent, and my guess is that it will be down to about 35 percent for the first half of this year. So the professional investors, whose funds are shown in Table 13, will be going back to a more traditional approach, although they are reluctant about it and are not going into it with any great enthusiasm. The investment community is plagued with what the economic community and the government are struggling over: a lack of knowledge about the structure of the supply side of the economy. There is no corporate program that focuses on this part of the equation, and too many investors and economists only operate from a demand orientation. Few understand the analysis of the supply side and what it means to product prices and corporate earnings.

The last point Al asked me to address myself to is "Do we really have to worry about a super-cycle?" We have had enough indications of the possiblity of a super-cycle from comments here today. Economies and financial markets are vulnerable to shocks. We have lost a great deal of our absorption power and are accident-prone. The debt cost is too high. I suspect the lending practices of some commercial banks are as sloppy as some of the stock prices were excessive in 1968 and 1969. This summer will see more bankruptcies than in some time. Offsetting this are a decline in commodity prices and a conservative consumer still fighting inflation. Psychologically, the market decline took place over the last six years, so that the compounding effect is no longer there.

In conclusion, as the economy contines to cool down, one can start to be more bullish about stock prices. But, as I have said at the last three meetings I have attended, it is a new ball game, as far as the selection of stocks is concerned. It will have to be, unless everything that has been said around this table is not so.

MR. WEIDENBAUM: Dan spoke earlier about the growing public disillusionment with big business as opposed to small business. The market is making funds available inversely to that, mainly to large companies, making it hard for small business to penetrate industrial markets. Any comment on that?

MR. GRANT: There is no question as to the widening quality spread between Aaa bonds and A bonds, let alone Baa. It has never been greater in modern history. For obvious reasons, lenders are concerned about other than top credits.

It is a real problem that compounds the banks' situation. The banks went in and normally made a commitment for a line with a small company on the assumption that in one year, two years, or three years, they would go out and raise some equity. Well, they just can't raise the equity. So the banks keep rolling them over; and if somebody had a debt ratio of say 50-50, with inventories up the ratio may soon be 70-30, without doing anything wrong or making any mistakes. So, I take the perverse attitude that as the economy falls below the general consensus, the outlook for the stock market is going to be better.

A stock-price upturn is the only way the individual buyer is going to return to the market. I do think if there is a sudden change in the political situation, as an example, there would be a sharp price rebound. But I think that for the first time in many years there are good yields on common stocks which will help bring the public back in. There are a considerable number of stocks, incidentally, which are substantially above their lows of the last couple of years. I suspect that the unweighted index will turn around much more rapidly and actively, and more broadly than the usual "averages."

There is still uninformed speculation in real estate to be resolved. We are doing it in commodities. These areas will be less attractive for the investor. But basically, you are going to have to get through an alternative yield competition with fixed-intent securities.

CHAIRMAN SOMMERS: Thank you, Bill. Let me revert to an aspect of inflation on which we have not reached a conclusion. Someone suggested that every time we protect one group against inflation, we intensify the rate and intensify everybody else's search for a shelter. What we have been talking about here really is an interplay between the rate of inflation and the institutions that cause it. It would not be difficult to build an accelerated model out of that. How many of you would subscribe to the proposition that what we are dealing with here is apparently that kind of cumulative process? The rate of inflation goes up and induces still more intense protective efforts which tend to elevate the rate still further.

MR. WEIDENBAUM: If we go the indexing route, we seemingly protect more and more of society against inflation. Hence, we diminish the essential ingredient of public support for anti-inflationary policy which is inherently distasteful, unpleasant and unpopular.

CHAIRMAN SOMMERS: And by so doing, we damage the growth rate and reduce the resources to be distributed. We have our hands on a large problem.

MR. EGGERT: Al, may I just comment that two years ago we were writing a report projecting our corporate plans for five years. We concluded that we would not return to the inflation rates of 1 to 2 percent we had earlier. It would be more like 3 to 4 percent. A year ago, we said we would not go back to 2.5 to 3 percent; it would be more like 4.5 to 5 percent.

MR. GRAYSON: One last comment. This is my first time with this group. But I have a need to try to come up with ideas to fight inflation. I was in Washington for a two-day seminar on inflation several weeks ago. Allan Meltzer uttered a cry over and over again: "Will somebody please come up with some concrete suggestions?" I don't have any magic answer. This is the politician's problem, and one he faults the economists on. He says, "All that is fine, but tell me, if you can, what am I going to do?" One thing he can do is nothing. But then *that* is a nightmare to many politicans, who say it doesn't do them any good when they are asked a question or speak on the floor of Congress.

Summary

Albert T. Sommers

Gentlemen, it is obvious that our discussion could go on for as long again as the time we have already put in, without exhausting this fascinating and illimitable subject. I know we agree that the record we have made today can hardly be considered the definitive story of inflation from cause to cure. But there is much here that is new, and we have brought much imagination and new emphasis to bear on aspects of inflation that have long been part of the public debate. Moreover, we have exhibited a striking willingness to skip rapidly over, and here and there to treat as trivial, much of what has passed for sophisticated analysis of inflation.

In approaching the summarization of this five-hour discussion, I am struck first of all by one overwhelming and incontestable fact. There is no one in this room – I should add emphatically, including your chairman – who is not thoroughly alarmed by the rate of inflation prevailing in the United States, and in the developed world as a whole. No voice was raised here for "a little inflation" as an economic stimulant, or even as a necessary concomitant to a high rate of growth.

We are agreed, to a man, that the prevailing rate of inflation – and the prospective rate of inflation over the next several years – poses the overriding threat to the economic, social and political stability of the developed world. All of us have long experience with the inscrutable ways by which a modern economy can frustrate the best efforts of forecasters. Yet many of us have been willing today to describe inflation as a profound challenge, on the way to becoming a crisis. If this transcript achieves nothing else, it will demonstrate the deep and candid concern over inflation of a distinguished group of authorities from the business, professional and academic worlds. We have obviously met on the right subject, at the right time.

Let me turn first to the causes of inflation, as we have described them today. Significantly, we have almost unanimously treated inflation in its present form as a social, political and historical phenomenon. We have distinguished very effectively, it seems to me, between a great social tide, as the initiating force of inflation, and a set of economic institutions and mechanisms which are essentially mediating and instrumental – capable of reinforcing and even accelerating the rate of inflation, but not originally responsible for it.

We have traced the real roots of inflation to a profound historical shift in the social conditions and value systems of democratic capitalism, and in the response of its political equipment. Modern economic systems in the free world are living in an explosion of expectations that carry the demands for output far beyond their finite resources, as a mounting stream of transfer flows and social costs is superimposed legislatively upon the normal costs of output. Our political system has grown increasingly responsive to ethical values which define a new kind of "equity" – a concept of economic justice less and less compatible with the value-free mechanisms of the marketplace. Increasingly, "fiscal constituencies" impose their economic interests on a receptive political system, in open bidding for benefits from government – including the benefit of protection from inflation itself. One speaker referred to this process as "a new spoils system"; another described it as the translation of aspirations into entitlement.

In another vein, we have viewed the modern economic system as seeking to achieve legitimate new social goals associated with a broader definition of the good life – a shift from a per-capita-consumption view of the purpose of the system - to a "quality-of-life" view, broadly incorporating environmental improvement, housing improvement, increased leisure, better working conditions, increased security, better education, better medical service, increased equalization of income, elimination of "poverty." I do not think we have taken the position that inflation is an inevitable consequence of such a change in the objectives of the system. But we have found the political process by which these new goals are developed and thrust into the system to be often irresponsible and even fraudulent, in that it ignores or disguises the true costs of the benefits sought. The "mixed economy" (this is a favorite term of my own; I am struck with the fact that we have not used it at all today) faces an excruciating problem of resource allocation, made more excruciating by the fact that the political preemption of resources by-passes the conventional allocation mechanisms of the market economy, and thus does not invite attention to the inevitable trade-offs – the hidden costs – of social uses of resources. The enormous problem of accommodating an historically market-oriented economy to a tide of social demands, and the failure of our political system to contain the growth of social demands within limits tolerable to the free market, is the essential first cause of inflation in this society, as it appears to be in all other democratic societies.

Because we have identified the general cause of inflation as lying outside the economic system itself, proposals to reduce the rate of inflation must come to grips with the social issues; the narrow technical prescriptions of economists can be only partial and inconclusive. It is thus not surprising that we have offered no very clear course of action against inflation – no easy list of purgatives. However, we have examined the existing economic equipment of this system closely, and we have focused on many components which appear to serve as the instruments of inflation, tending to perpetuate it, and even to accelerate it. We have also spelled out, I think ominously, the economic consequences of accelerating inflation. And we have offered some proposals that will modify these consequences and perhaps "buy time" in which, we might hope, the fundamental causes of inflation will come to be more widely recognized. There is no panacea in this conversation; but there are some trenchant observations about how our economic machinery now works, and at least a few suggestions on what can be done to improve its price performance.

We now turn to the conventional policy equipment of the American economy and its role in domestic inflation. On the whole, our speakers on these subjects have argued that our fiscal and monetary practices have been partly subverted by inflation itself, and collaborate with it ("validate it," as we frequently said) as much as they resist it. A little surprisingly, given the tenor of the prevailing monetary debate over inflation, we have focused more on fiscal sources of inflation than on monetary sources. Given the social and political causes of inflation, their entry into the economic system itself is through the legislative responses which make our fiscal policy. As a group, we have accepted the argument that public deficits are a principal cause of inflation, although some of us have questioned whether the size of the reported deficits is consistent with the large consequences we seem to attribute to them. In response to this qualification, our expert on fiscal policy argues that the actual deficits are characteristically understated, in some degree by exclusion of agency debt, but much more importantly by the exclusion of the extreme growth of government-guaranteed debt.

The impact of the rise in public debt outside the conventional budget is such as to have partly socialized the long-term capital market, compromising the access of the private sector to long-term funds. Our generalist on the subject of inflation argued that it is the insensitivity of public debt to interest rates that accounts for the rising proportion of public and guaranteed debt, and ultimately requires the Federal Reserve to create substantial additional liquidity to accommodate the private sector, whose demand for funds is responsive to interest rates. The political compulsion to spend in the public sector, and to guarantee debt in socially significant parts of the private sector, thus causes excessive growth in the aggregate money supply and thereby translates political pressures into price pressures.

Our representatives in the areas of fiscal and monetary policy also appear to agree with our generalist that inflation and the accompanying rise in interest rates pose a crucial threat to thrift institutions, whose long-term portfolios make it impossible for them to survive in an environment of extremely high short-term rates. Our speaker on this subject suggested that the disintermediation among thrift institutions would reach a catastrophic level at a short-term interest rate of about 15 percent, and that the inevitable efforts of the Federal Reserve System to preserve these institutions under such conditions would evoke a runaway rate of creation of money.

In this view of the inflation process, we spoke of monetary policy as essentially a mediating mechanism, with few substantial options open to it and, in the end, with no ultimate responsibility for inflation. Over the long run, the money supply is effectively controlled by the monetary base which, in turn, is effectively controlled by the Federal Reserve. But in the end, confronted by a rising tide of public and publicly guaranteed spending, resting on the privileged position of government in the money market, the Federal Reserve has no alternative but to provide funds through additions to the monetary base. There is here no direct criticism of the monetarists' propositions with respect to inflation; but as I understand our discussion today, the monetarists' injunction to fix the rate of growth of the money supply at a moderate figure and leave it there with the confidence that inflation will abate is simplistic, in that it ignores the true political causes of inflation and of the growth in the money supply itself. We have almost (but not quite) said that in the absence of rapid creation of funds, the private sector would shrink even faster, relative to the public sector. The Chicago School will not read this document with enthusiasm.

Our representative on the subject of monetary policy offered only small comfort to this concerned view of its role. If I understand him correctly, he has found policy to be more pro- than anti-cyclical, with periods of excessive monetary creation in times of expansion followed all too quickly by monetary validation of cost-push inflation in the ensuing periods of economic readjustment. He finds the tools of monetary policy theoretically adequate, if they were to be used, but they pose the threat of "crisis"; one of us spoke of the tools of monetary policy as representing a "nuclear deterrent," whose use may be foreclosed by the predictable consequences. He spoke of the current options open to the Federal Reserve as limited to seeking a precarious balance between still more rapid inflation on the one hand, and severe liquidity problems on the other. Among other speakers, he pointed with discomfort to the shrunken liquidity of the business system, and of the banking system itself.

Perhaps a little surprisingly, only a minority of us would now advocate enlarging the Federal Reserve's powers to deal with such a delicate quandary; only about a third of us, for example, urge the Federal Reserve to seek additional selective credit controls.

In a poll taken a week prior to our meeting, seven of the nine participants in this discussion voted for restrictive monetary policy for the further control of inflation in 1974 and 1975. Seven also voted for restrictive federal budgetary policy. With respect to the remaining general arm of anti-inflationary policy, namely, an incomes policy, the views of this group are divided. None of us proposes mandatory direct controls, but three of us vote for wage and price guidelines. Our representative on monetary policy argues that there is a place for an incomes policy if it is supported by appropriate fiscal and monetary conditions; and our speaker on wages, productivity and labor costs expresses regret at the instant termination of controls a month ago. He would have preferred a continuing control over construction costs, where he foresees substantial wage escalation, and perhaps in other areas as well. And my impression is that he and at least one other member of the group would envision a permanent place for nonmandatory guidelines as a focus of public policy, and a control of some value over the wage-price feedback relationship.

On the other hand, a number of our participants, including our guest Jack Grayson, formerly Chairman of the Price Commission, finds that the administration of any incomes policy leads inevitably toward increasing intervention into the market system, and must eventually lead back to direct control over wages and prices. Moreover, the process of wage and price control threatens, in the experience of the Price Commission, to converge ultimately on the control of profit itself, and hence on the general allocation of resources in the system. Nevertheless, there is some disposition on the part of this group to expect periodic reappearance of an incomes policy, as a tactical response to inflation, although none of us envisions it as reaching the real causes of inflation. In the current burst of inflation, wages and union power come off relatively lightly in our discussion. We attribute little of the 11.5 percent inflation rate of early 1974 to wage inflation, and our speaker in this area has noted the decline of the real wage over the past year. But an intensified wage-push is undoubtedly coming, and the uses of wage escalation will doubtless spread in 1974 and 1975.

While we have recognized the market power of unions and its role in inflation, we have placed far greater stress on fiscal and monetary mechanisms as the long-term carriers of inflation, and we consider that our fiscal and monetary instruments comprise our principal weapons against inflation. [If I may step out of the role of summarizer for a moment, I regret that we spent only a little time appraising the adequacy of our traditional monetary and fiscal institutions in an economy dedicated to full employment. And I regret that we have not debated the uses of public employment and manpower training programs, in which a clear majority of us expressed an interest in our poll (see Table 1). On another occasion, I hope we will pursue these institutional, instrumental issues in the control of inflation in a modern economy.]

With respect to the causes and perpetuation of inflation, one other theme runs through our comments. We appear to agree that in the presence of the political pressures developed in a modern democracy, consumption tends to be augmented at the expense of investment. Within the economic system itself, the resources devoted to conventional consumption are excessive, even though, as our sociologist member suggested, the real demands for consumption goods of a conventional character are perhaps less pressing than they used to be. His surveys disclose increasing concern on the part of the average wage earner for better working conditions, better family conditions, more leisure, "a lifting of the nose from the grindstone," as distinguished from the long-term struggle to elevate conventional living standards. Our record is not clear on this issue, perhaps because as a nation we are in transition from the historic dedication to a standard of living, defined in terms of traditional consumption goods, to a standard of "quality of life." But we are agreed that, altogether apart from the psychological state of consumers, our resource allocation provides inadequately for investment and future growth.

Our speakers on domestic and international financial conditions have echoed the concerns expressed by the speakers on policy subjects. Inflation is multiplying the capital requirements of business. The interest rates associated with inflation have produced a 70 percent decline in the U.S. equity market since its peak in 1968, and a virtual vanishing of the opportunity to reach new equity capital. The result has been an extraordinary, and now perhaps dangerous, rise in the relationship of debt to equity, and a general critical shortage of productive capital for industry as a whole, and for banks in particular. Rapid inflation of inventory costs and the cost of capital facilities is distorting conventional accounting, and increasingly requiring two sets of accounts, one of which properly reflects real earnings on a true replacement basis. The equity market itself (and the bond market as well, of course) has already paid an enormous price for inflation; a substantial degree of adjustment has already been completed, and it is difficult to see still further declines in equities. However, until useful and effective responses to inflation itself are developed, the equity market cannot perform its essential function of attracting and allocating risk capital.

Our international financial spokesman likewise sees world inflation mounting toward a crisis level in the presence of weak and divided national governments throughout most of the free world. In the presence of double-digit inflation, we should expect no important progress on reform of the international monetary system. The problem of international inflation is complicated by the collusive power of nations producing raw materials in a world of scarcity; the petroleum illustration of this danger is dramatic, and while the financial flows generated by the elevated price of crude oil may be tolerable for 1974, they are awesomely destabilizing in the long run. Individual nations of the western world are all using the same techniques to fight inflation, and getting less results than we are; nor is there any real agreement on a worldwide approach to reduce the general rate of inflation.

I should comment, in conclusion, on two further threads of our discussion today that I believe draw us together into a general consensus. First, it appears to me that we accept the conclusion that the kind of inflation now being experienced in the western world is inherently cumulative. One of us phrased this cumulative process in terms of progressively higher interest costs required to maintain the saving function, followed by massive additional injections of funds to salvage those institutions which find the rise in interest costs intolerable. Others of us find a cumulative mechanism in the deflection of resources toward personal and social consumption, the deterioration of investment and growth, and increasing scarcities as the supply side of the system falls further and further short of the dollar demands. Still others of us, myself included, see the process as cumulative because we observe continued pro-inflationary changes in our economic institutions as we struggle to accommodate to any given rate of inflation: total indexing stands as perhaps the ultimate such accommodation. The poll of our own expectations with respect to the rate of inflation over the next eighteen months disguises this general conclusion, because virtually all of us expect a decline in nonrecurrent elements of inflation attributable to the sudden elevation of costs of food and energy in late 1973 and early 1974. While we expect inflation itself to be lower in the next several quarters, we have clearly treated this prospective decline as a temporary remission. Unanimously, I think, we argue against complacency.

Finally, because we have placed the ultimate causes of inflation in a political and social context, it is in political and social attitudes that we must hope for the ultimate adjustments. Our sociologist has commented that the U.S. consumer remains relatively conservative with respect to inflation; he has not abandoned saving, although he is growing more sophisticated with respect to the repositories he trusts. Nor is there any upsurge of American sentiment to forsake the free market in favor of massive public ownership of resources and central planning. At one point or another in our discussion today, almost all of us have referred to the critical need for distinguished political leadership that will array our priorities; set out with conviction and credibility the costs associated with the economic benefits we seek through the political process; and contain our aggregate public and private demands within the limits of our resources, with an adequate margin for reinvestment and growth. As one of our speakers put it, "This is a man-made problem, and men can solve it."

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1. ROBERT J. EGGERT, Vice President, RCA Corporation.
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3. ALAN GREENSPAN, President, Townsend-Greenspan and Company, Incorporated.
4. WALTER E. HOADLEY, Executive Vice President and Chief Economist, Bank of America National Trust and Savings Association.

*5. ALBERT G. MATAMOROS, Vice President and Chief Economist, Armstrong Cork Company.

*6. PAUL W. McCRACKEN, Edmund Ezra Day University Professor of Business Administration, Graduate School of Business Administration, The University of Michigan.

7. JAMES J. O'LEARY, Vice Chairman of the Board, United States Trust Company of New York.
8. ALBERT REES, Class of 1913 Professor in Political Economy, and Chairman of the Department of Economics, Princeton University.
9. ALBERT T. SOMMERS, Senior Vice President and Chief Economist, The Conference Board.
10. MURRAY L. WEIDENBAUM, Edward Mallinckrodt Distinguished University Professor, Department of Economics, Washington University.
11. DANIEL YANKELOVICH, President, Daniel Yankelovich, Incorporated.

Guest of the Forum

C. JACKSON GRAYSON, JR., Dean, School of Business Administration, Southern Methodist University.

*Unable to attend May 21st meeting.

Foreword

ON MAY 21ST, The Conference Board's Economic Forum met in New York to explore the subject of inflation. The Forum's five-hour conversation on this fundamental issue confronting the United States, as well as other developed countries throughout the world, is recorded here.

Experts on individual aspects of inflation – its causes, its consequences, the policy equipment with which we seek to restrain it, and the real and financial effects of the struggle against inflation – offer their views, and respond to the searching questions of their colleagues. In a concluding section, the Board's Chief Economist, who serves as Chairman of the Forum, summarizes the essence of a discussion that covers an enormous spectrum, ranging from broad social conditions to the complex behavior patterns of the world money market.

No one would suggest that the last word on the causes and cures of inflation can be found here. But the Forum's Proceedings offer an intensive and readable record on the significance of inflation, and the threat it poses to modern society.

It is my pleasure to extend the gratitude of The Conference Board and its Trustees to the distinguished authorities who comprise the Forum (and to a distinguished guest of the Forum, C. Jackson Grayson, Jr.), for their participation in this significant meeting.

The transcript of the Forum's Proceedings was prepared for publication by Lucie Blau, assistant to the Chief Economist. Final editing was done by Lillian W. Kay. The art work was produced by the Board's chartroom, under the direction of Rosanne Reilly.

ALEXANDER B. TROWBRIDGE
President

June, 1974

Table 1: Results of Economic Forum Poll, May, 1974

1. What are your expectations for the rate of inflation (the GNP deflator) in late 1974?

3%	4%	5%	6%	7%	8%	9%	10%	11%	over 11%
			1	5	3				

2. What are your expectations for the rate of inflation (the GNP deflator) in late 1975?

3%	4%	5%	6%	7%	8%	9%	10%	11%	over 11%
		1	5	1	2				

3. Which of the following devices would you favor for the further control of inflation in 1974-1975? (Check as many as you wish.)

7	Restrictive monetary policy
3	Selective credit controls
0	A general tax increase on corporations
0	A general tax increase on individuals
1	A value-added tax
7	Restrictive federal budgetary policy
3	Wage and price guidelines
0	Mandatory direct controls
6	Labor legislation to improve the functioning of the labor market
7	More emphasis on a public employment program and manpower training programs
1	Tax incentive for research to aid productivity

4. What percentage increase do you expect in average hourly earnings in 1974?

under 5%	5%	6%	7%	8%	9%	10%	11%	12%	over 12%
			1	5	2	1			

5. What percentage increase do you expect in average hourly earnings in 1975?

under 5%	5%	6%	7%	8%	9%	10%	11%	12%	over 12%
				6	2	1			

6. What percentage increase do you expect for productivity in the private economy in 1974?

zero to negative	1%	2%	3%	4%	5%	6%	over 6%
2	5	1	1				

7. What percentage increase do you expect for productivity in the private economy in 1975?

zero to negative	1%	2%	2.5%	3%	4%	5%	6%	over 6%
	1	1	2	3	2			

EXCERPTS FROM STATEMENTS OF FORUM PARTICIPANTS

Alan Greenspan — A General View of Inflation in the United States

The United States is rapidly approaching the crisis threshold of inflationary expectations which, if pierced, threatens massive economic disruption. Unless major economic policy changes are forthcoming, a crisis by 1977, or even 1976, is a reasonable probability. The level of the threshold inflation rate (and its associated interest rate) is determined by the size and nature of our peculiarly American thrift institutions. (The nature of these institutions places the crisis threshold far lower in this country than elsewhere in the world.) These institutions can barely retain deposits when short-term money rates are in the area of 9 to 9.5 percent. They are threatened with massive withdrawals amounting to tens of billions of dollars if short-term interest rates move close to 15 percent. Should this upper level be penetrated, the Federal Reserve's response would be immediate — and massive — support for the thrift institutions. This, in turn, would create such a huge expansion in the money supply as to doom all reasonable efforts at future restraint. Such a crisis might well put us beyond the scope of any conventional solutions to our inflationary problems within this decade.

The underlying cause of our inflation is the rapid acceleration in federal spending and credit-guarantee programs. Financing under federal auspices has been appropriating an ever-increasing share of the nation's savings, thereby forcing the Federal Reserve to expand bank credit to finance the growing credit demands of the nonsubsidized sectors of the economy. Hence, a moratorium should be quickly placed on all federal programs which create new expenditure initiatives (health insurance, welfare reform, etc.). Moreover, we should cut current outlays to the point where the unified budget (including federally sponsored credit agencies) is in significant surplus.

Ad hoc short-term solutions no longer are capable of coming to grips with the problem. Price and wage controls should be eschewed at all costs. To the extent that they work, they suppress, rather than eliminate, inflationary forces which then build up behind the controls and ultimately worsen, rather than help, the situation. While a major tax increase would have short-run favorable effects on inflation psychology, past history suggests all too convincingly that increasing available revenues merely stimulates new spending programs.

James J. O'Leary — Inflation and Monetary Policy

There is no doubt that the basic force behind the inflation of the past several years has been an excessive increase in the supply of money. Many economists would say that excessive monetary expansion has been the sole force behind the rise of prices, but in my opinion this is a simplistic view of inflation. Chronic deficit financing by the Federal Government in the past several years has been a powerful force in itself, aside from the fact that much of the deficit has been, originally at least, financed in the banks. Moreover, the upward push of costs has at times, such as in 1969 and 1970, been a major initiating force toward inflation, and it is subsequently validated by a high rate of monetary expansion. As a matter of long-term trend, the low rate of productivity has also made the United States vulnerable to inflation.

The strong political pressures for vigorous growth and full employment have restricted the options open to monetary policy. This is illustrated particularly by the dilemma now confronting the Federal Reserve. With "double-digit" inflation under way as the wage-price controls have been removed, a high rate of monetary expansion is required simply to carry out business transactions. The Fed's strategy seems to be to fight a rearguard action against this — that is, to permit a high rate of monetary expansion, but not as great an increase as the economy is demanding. The result is a sharp increase in short-term interest rates, which is expected to be the cutting edge for curbing the inflation. In a period of "double-digit" inflation it takes a record level of short-term rates to do the job. I think that we are now witnessing a slackening of loan demand which is in part the result of the high rates. The high cost of certificate of deposit (CD) money to the banks is also an important factor, cooling the ardor of the banks to expand loans. Moreover, as short-term rates have risen, the savings institutions are undergoing a severe "disintermediation," which will cut the availability of home mortgage credit and thus curb housing in the months ahead. The rise of interest rates has also had a bearish effect on the stock market, which affects the confidence of the consumer.

We have come to a point in our economy where it is imperative that monetary policy — and public policy as a whole — be directed toward bringing down the inflation rate. Public policy in the United States has for many years given too high a priority to vigorous growth and full employment and far too little priority to price stability. This has been true also of other industrial countries. This is why there is so little confidence around the world today in paper currencies. This is why I am encouraged by the present course of Federal Reserve policy, even though it is a dangerous and difficult course after we have permitted inflation to run so strongly. But the Fed must remain tough. And we must not undermine its efforts by larger federal deficits, or even by direct government programs to stimulate housing.

Murray L. Weidenbaum — Fiscal Policies and Inflation

In order to use fiscal policy more effectively in fighting inflation, we must update both our factual knowledge and our methods of analysis.

The situation facing us in the year ahead will not be that of a modest federal deficit offset by large state and local surpluses. The federal deficit in fiscal 1975 will be higher than this year and probably higher than the official forecasts. So-called "uncontrollable" outlays (social security, interest, etc.) have overrun the original estimates by about $7 billion a year since 1969.

Nor are state and local governments running large surpluses. We have been looking at the wrong indicator. They ran a cumulative budget deficit of $4.4 billion for fiscal years 1971 and 1972 (in contrast to the National Income Account reports of a $10.9 billion surplus).

Those who rely on a prospective surplus in the full-employment budget to demonstrate fiscal restraint are using an out-of-date indicator, which has fallen a victim of inflation. In "real" terms, the full-employment budget will register another deficit in fiscal 1975. The continued high level of inflationary pressures requires a further tightening of fiscal policy.

Albert Rees — Wages, the Wage-Price Cycle, and Incomes Policies

Wage increases during 1973 and the early months of 1974 remained quite moderate, with most measures showing increases in the range of 5 to 7 percent. Since these are smaller than the increases in consumer prices, the real hourly earnings of private nonfarm production workers dropped 3 percent in the twelve months ending February, 1974.

There are now clear signs that we have entered a new and different period. Settlements in the period since the end of wage control have been in the 10 to 12 percent range, and could go higher in such areas as heavy construction and bituminous coal. Multi-year collective bargaining agreements now generally include escalator clauses, but most such clauses in the private sector do not provide complete compensation for rises in consumer prices during the life of the agreement. In my opinion, such clauses are a reasonable price to pay for the settlement and prevention of industrial disputes and will not interfere with a gradual decrease in the rate of inflation.

The higher demands of trade unions in the months ahead are not likely to lead to a dramatic increase in strikes, since in many cases they can be met from the large increases in profits that have already occurred. However, unless there is some moderation in new settlements, there will be a growth of sentiment for the reimposition of some wage controls.

C. Jackson Grayson, Jr. – Inflation and Free Enterprise

Inflation persists for the next 2 to 3 years in the 5 to 8 percent range. The Congress, Executive Branch, and Fed attempt to moderate public demands, but they are unwilling to take measures to deflate. The cry increases to "do something!" A new form of wage-price control is imposed. Inflation momentarily subsides; controls are dropped. Investment meanwhile also drops. Unemployment increases, spending increases, inflation restarts. A "new" control program is created. And so on. Each time through the cycle, real economic growth slows, investment declines, productivity falls off, and the central government steadily increases its penetration into the competitive market system.

This is no imaginary scenario. It is taken from observation of experiences since World War II in most European nations. The end could be an American repetition of the "British sickness." Unless we tackle inflation on a broad front – in its many dimensions – with firmness and leadership, and not treat just the symptoms, then the scenario will come true.

First, we must have a determined moderation of both fiscal and monetary policy for a period of *years*. We must move on a steady progression of deregulation of our industries by many regulatory bodies (ICC, FPC, FCC, CAB, Agriculture, etc.). We must increase *productivity* through stimuli for capital investment and for human "quality of work." We must increase the level of *economic education* throughout the nation: in the Congress, in secondary schools, in executive suites, on the shop floor, in the home. Finally, we must have people who *speak up* for free markets, for competition, for open advocacy of capitalism.

Walter E. Hoadley – Inflation in an International Context

The rate of inflation across the world – now averaging at least 12 percent – seems to be approaching a point of no return without a fairly severe international economic adjustment. The threat probably is not imminent for 1974, but the danger is mounting. More than ever before, broad regions of the world are experiencing the same problems simultaneously, and facing much the same consequences. The world economy is growing increasingly vulnerable to recession.

Inflation is already a strong contributing factor to political changes in leadership in many nations. It is helping to drive international interest rates to dangerously high levels; dislocating traditional debt-equity ratios; inducing speculation in land, commodities and other real assets; and straining many already precarious international payments positions. Yet there is no sign of agreement on any promising worldwide approach to check inflation.

It is increasingly clear that no single nation can hope to resolve its inflation problem alone because of now strong economic links among nations. The efforts of individual nations to check inflation seem less and less effective as the swirl of rising prices engulfs them. The stronger their restraint programs, the more economic and financial casualties.

At the root of the problem lie unrealistic expectations for the rate of economic improvement to be achieved in a developed world already operating near full employment, in the face of the rising economic power of resource-wealthy developing nations. The immediate response to inflation must lie in an urgent appraisal of *supply* prospects and a determined investment effort to expand capacity in all sectors where chronic shortage conditions threaten to intensify inflation over the years ahead.

On the horizon are enormous problems of recycling Arab oil funds through financial markets and institutions which are not ready to accommodate them. We must be prepared for more strains in all major markets, strong tendencies among nations to use domestic controls and exchange rates in their own defensive interest, and resort to such remedies as buying time through increased borrowing arrangements for oil-consuming nations and a higher official price for gold.

Americans, and others, need some signs soon of price relief. Hopefully, some are on the horizon now, especially in commodities. But this condition is likely to be short-lived. It is high time for international agreement on a concerted anti-inflationary fiscal and monetary program, plus a massive program to meet the world's future needs for goods and services.

Robert J. Eggert – Inflation and Personal Consumption

The galloping U.S. inflation of the last half of 1973 and the first quarter of 1974 is expected to subside in the second half of 1974 and in 1975 as food prices increase less rapidly, plant and equipment investment begins to modify areas of severe shortages, and inventory building and exports begin to diminish as a result of sluggish real growth in the United States and throughout the world.

In contrast to an advance in the consumer price index throughout the first half of 1974 of 12 percent, it is expected that, in the fourth quarter, the increase will be 8.5 percent. Furthermore, by the fourth quarter of 1975, the consumer price index can be expected to rise by only 6.5 percent – a substantial downward adjustment from the two-digit figure for the first half of this year, *but still too high for comfort.*

In recent years, inflation seems to be discouraging consumer saving. Perhaps consumers are reacting more like businessmen – buying before prices go higher instead of attempting, as they have traditionally, to ward off the effect of future inflation by saving more.

In our judgment, inflation will not be ended quickly, or without pain to certain segments of our economy. Caution must be exercised by the Federal Reserve Board in steering a reasonably restrictive monetary policy, and at the same time allowing enough expansion in the money supply so that the economy can maintain reasonable real growth. Even greater caution is needed by Congress in avoiding huge deficits in federal budgets during the years ahead.

Daniel Yankelovich – National Attitudes and Inflation

The political mood of the country is off balance; the problems seem unusually severe; we are losing our world economic leadership; confidence has been shaken. We see a decline of public confidence in both business and government, but the declines are not identical. The decline in confidence in government arises because it is perceived as not doing its job in policing business. The villain is big business. But whatever has happened with inflation and Watergate has not shaken the basic support for free enterprise. No general desire for business to be taken over by government; no economic radicalism, but rather a specific finger pointed at greed itself – a human model of greed, not a theoretical model of economic exploitation.

There does not seem to have been any intense increase in the desire for redistribution of income, or a new thrust toward equality. Acceptance of the way the system generally works is still deeply ingrained. But we have papered over many potential social problems in the United States, because of our rapid industrial growth based on cheap energy and the ability to use disproportionate amounts of the world's raw materials and resources. What we are witnessing is not a massive increase in the sense of entitlement on the part of the public, but the desires that we ourselves have stimulated for higher aspirations, for higher demands for products, for higher levels of material well-being. And it takes a high growth rate to meet these demands. Among those who have had a taste of affluence, it has been demystified. But the mass of the public who haven't had that are committed to it, in a traditional sense, and also to the welfare state.

There remains a partially submerged tradition of puritanism in the American people. A shift in emphasis (away from materialism) would be greeted by some with an enormous sigh of relief.

William R. Grant – Inflation and Financial Markets

The current rate of inflation distorts financial statements and financial analysis and makes all investors uncertain and cautious.

Corporate managements are encouraged by product-price realizations which are running ahead of wage increases. But cash requirements for inventories are rising rapidly, distorting short-term financial needs. Dividend payout as a percent of earnings is less meaningful because of rising cash needs for higher plant costs. In these circumstances, it is almost impossible to do intelligent corporate planning. In this type of suspicious environment, investors like dividends as something "real," as opposed to the problematic long-term potential of earnings growth.

The key question is how much these real and imaginary problems are already discounted by a stock market in which the unweighted index of *all* markets is down 70 percent from its 1968 high.

European professionals regard U.S. markets as the cheapest and most attractive politically until they visit their U.S. counterparts and are discouraged by their pessimism.

The stock market would respond positively to good political news (a Watergate solution), international news (a Mideast settlement), and economic news (lower inflation and interest rates). The behavior of the bond market is nothing short of miraculous, considering where interest rates "should be" with this rate of inflation. It reflects a "feel" that the rate will decline significantly, by year-end. If the rate of inflation is not down significantly, Aaa bonds will yield over 10 percent, and the yield spread as between high- and low-quality bonds will widen further.

Corporate liquidity is still low. The medium and smaller companies and lesser-quality large companies cannot sell equity. This is another burden on commercial banks, and, along with higher inventory costs, has been the prime factor in the rise of short-term rates. Corporations now need large amounts of equity; when it is unattainable they must resort to more debt. If present trends continue, the U.S. financial market will resemble those of Europe and Japan: illiquid markets, dominated by government agencies and large financial institutions.

Inflation In the United States:

Causes and Consequences

CHAIRMAN ALBERT T. SOMMERS: Gentlemen, on behalf of The Conference Board, I welcome you to this midyear meeting of the Forum. In the light of recent developments in U.S. price indexes, I would guess we are all entirely satisfied with our decision of several months ago to forego our usual midyear outlook review, and devote this session exclusively to the subject of inflation. We turn first to you, Alan, for a general view of inflation in the United States.

A General View of Inflation in The United States

Alan Greenspan

MR. GREENSPAN: I think that there is a generic fiscal-financial-monetary cause of inflation which essentially overrides all other considerations. Put another way: I do not believe that, in the longer run, the general price level is determined by the sum of its parts. I do acknowledge that in the short run specific price patterns – in oil and food, for example – can, and do, dominate the published indexes. But I doubt very much whether one can make a persuasive case that one can forecast or, in fact, even understand the behavior of an average price level by looking at its components.

The relationship between the price of steel, for example, and the price of wheat is a relative concept – that is, it is determined by the relative supplies and demands, and the absolute price level of each is not determined by that relationship, but by the aggregate price level. Algebraically we know, of course, that if we define all relative prices – that is, the relationship of one price to all others – and state the total price level, all individual prices are algebraically simultaneously calculable. I submit that is a bit more than a statistician's calculation; it is something not terribly different from the process by which our price system is determined.

It is interesting in this regard to look at the most recent behavior of the GNP implicit price deflator, which is, with all its imperfections, a useful general measure of the overall price level. In Chart 1, I have plotted "unit money supply" – in this case defined as M_2 divided by real GNP – against the GNP implicit deflator. What we are looking at is an exceptionally close correlation. You can torture yourself into all sorts of reverse cause-and-effect concepts, and I certainly acknowledge that many of them are partially valid.

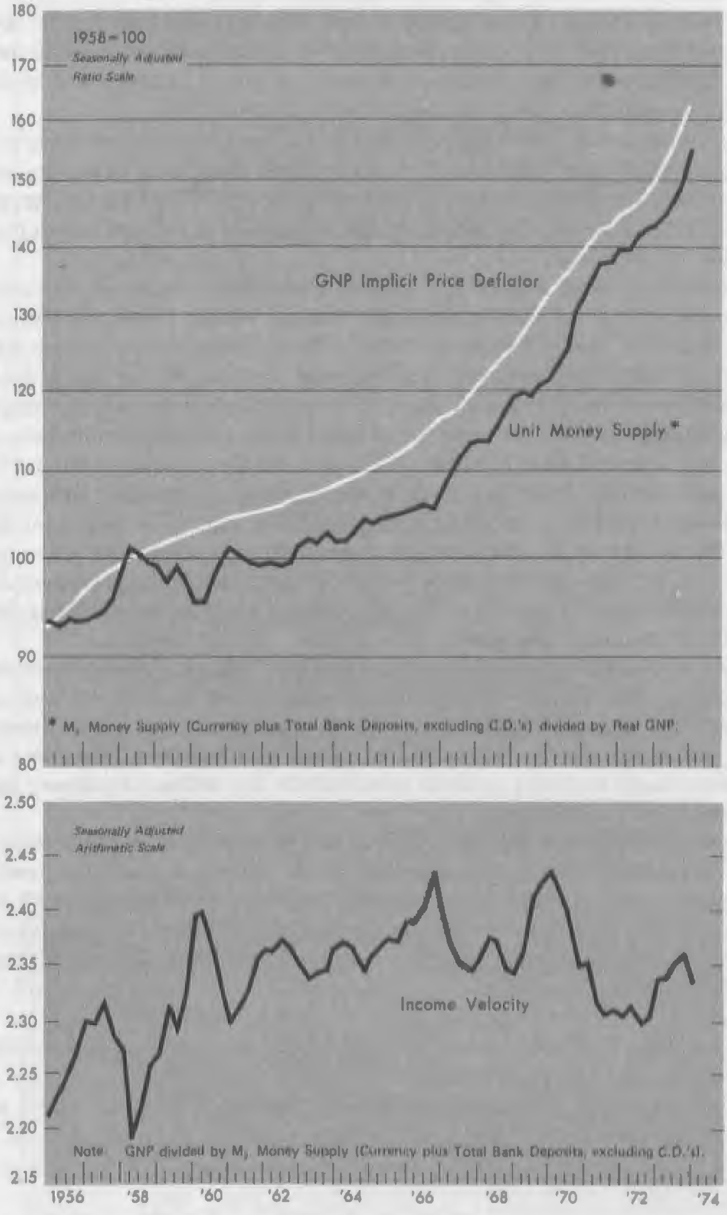
Nonetheless, we do observe over a very long period of time – say back to the post-Civil War period – a surprising stability in the ratio of GNP to money supply. Income velocity has no significant trend. If income velocity has no trend, algebraically, unit money supply is directly proportional to the price level. So, as the first layer of inflation causation, I submit that it is in the behavior of unit money supply.

The question, however, is: what determines the money supply? There are all sorts of attempts in various econometric systems to try to make money supply endogenous. I find these most unpersuasive. I believe it is clear that money supply is determined by the monetary base and that the central monetary authority, the Federal Reserve, has absolute control over that base, given any specific lead time which it chooses.

MR. EGGERT: Absolute control?

MR. GREENSPAN: Absolute. The monetary base, not money supply. The Fed has complete control over the base and can, if it wishes to, create any volume – provided it knows what the Treasury is doing.

Money Supply and Its Relationship to Prices and GNP *Chart 1*



Sources: U.S. Department of Commerce; Federal Reserve Board; Townsend-Greenspan and Company, Inc.; The Conference Board Chart Service

CHAIRMAN SOMMERS: You were talking about a direct theoretical control. Would you distinguish cases where the consequences of rigid control are serious?

MR. GREENSPAN: I am about to get to that. The question is: granted this complete statistical, or theoretical, control of the monetary base, is the Fed, in fact, independent? My conclusion is that it is not; it is controlled by certain key political variables.

The conventional explanation of this is to emphasize unemployment rates. Frankly, I think that's irrelevant. I don't think that, as is often argued, the Employment Act of 1946 is the cause of our inflation. If that act had never been passed, we'd still be exactly where we are. The inflation process comes from the fiscal side of the system.

We have been dealt a good deal of very questionable economic statistics and theory concerning the full-employment budget which, I assume, Murray will shortly get to. I concur wholeheartedly with his point of view, and my only concern is that that concept was allowed to get as far as it has. The full-employment budget, in my view, is a very poor measure of the impact of government on the economy, or the impact of federal spending on inflation.

The way I would view it is this: there is a certain amount of net borrowing which goes on by both the Federal Government – directly and indirectly through the federally sponsored credit agencies – and state and local governments. In and of itself, this would not be a terribly significant phenomenon, were it not for one very important issue – namely, that these governments tend to be wholly interest-insensitive to the process of borrowing. Their interest elasticity of demand is negligible.

Since an ever-increasing proportion of private saving is being borrowed by governments, the average inelasticity of demand of the money and capital markets rises. Or, put another way, the amount of savings left to finance the private sector shrinks. Governments, in effect, elbow private borrowers out of the capital markets simply because governments are willing to pay any interest and private borrowers are not.

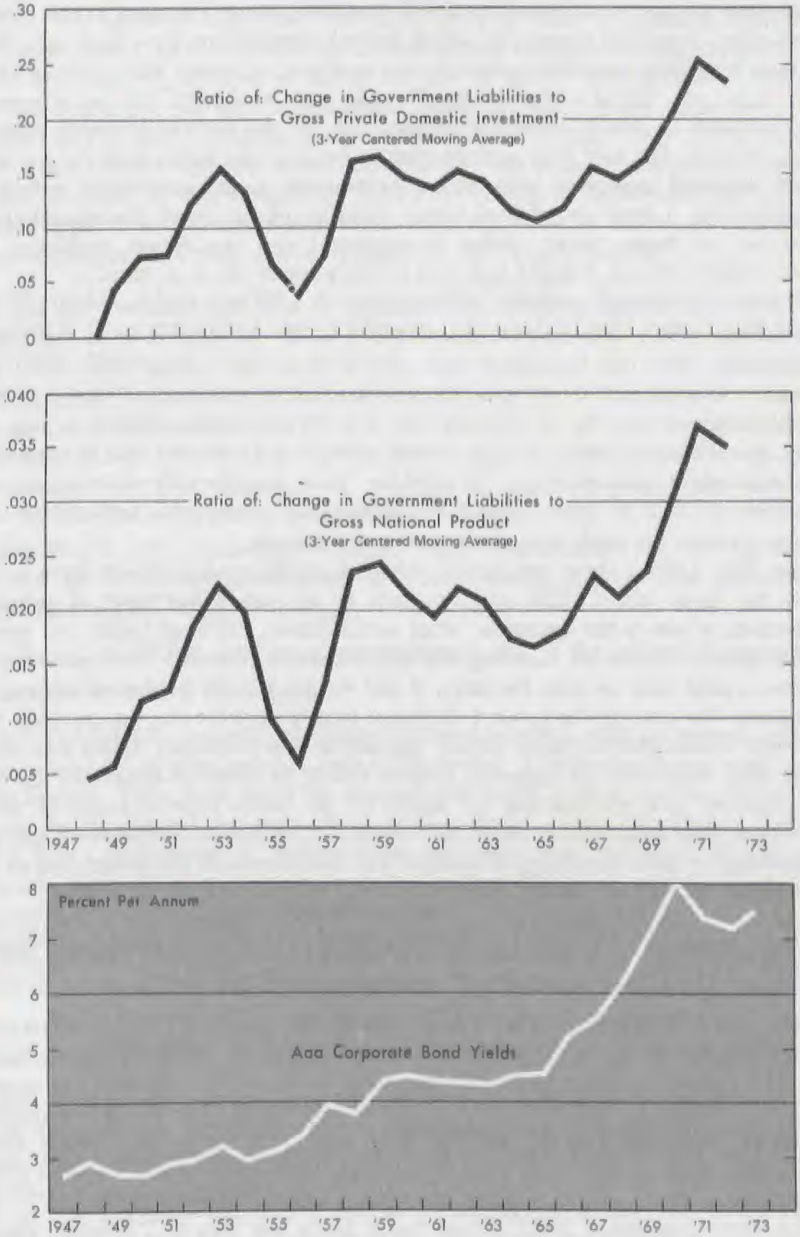
This is not done in a manner which is not without cost, because there is, in fact, a considerable degree of inelasticity in the private demand for funds. The equilibrium point, where the demand and supply of funds is cleared by the interest rate, is at an astronomical real rate of interest. Well, before this process gets very far, the pressure on rates forces the Federal Reserve to increase reserves of the banking system to supply financing to the private sector of the economy.

This process, which we have seen accelerate in recent years, is the next layer of inflation causation. The numerator in the two top lines of Chart 2 is the sum of the net increase in Treasury liabilities, federally sponsored credit agency liabilities, and state and local liabilities less intergovernmental transactions.

MR. WEIDENBAUM: Of a debt nature?

MR. GREENSPAN: Yes. These are the Federal Reserve's flow-of-funds data. As a proxy for private savings – the denominator of the ratio – I used gross private domestic investment as one measure, and gross national product as the other. It wouldn't matter what measure I took. Both are three-year moving

Relationship of Government Liabilities to Investment and Output *Chart 2*



Sources: Federal Reserve Board; U.S. Department of Commerce; Moody's Investors Service; Townsend-Greenspan and Company, Inc.; The Conference Board Chart Service averages. The ratio is up sharply in recent years. And I think it does coincide relatively well with the process seen in the earlier chart.

One can then ask about this layer of causation: what is making this happen? And then we get to a question, which I believe I have discussed at this Forum previously, about the process by which federal expenditures have built into them an ever-increasing escalator caused by our political processes. Many of you know my view of "fiscal constituencies" and the tendency for governmental expenditures to rise at an ever-increasing rate for the nondiscretionary areas of expenditures. The fact that outlays tend to rise at a rate faster than the so-called fiscal dividend generates increasing governmental credit guarantees instead of expenditures. I have not delved into a number of the other guaranteed credit programs in these charts, owing to statistical and conceptual problems. No matter what you use, I might add, you get very much the same results.

There is a serious question, for example, of how one handles FHA and VA guarantees. There is a market effect, but I doubt whether it is of significant dimensions. But the Lockheed loan clearly is an interest-inelastic credit and there is a whole slew of new federal guarantees under rural housing. The credit-guarantee process is accelerating. It leads me to the conclusion that the only way to bring inflation back under control is to reverse this fundamental process, which gets us back to curbing the governmental expenditure and guarantee process or, more exactly, the proportion of the gross national product which is under the control or auspices of governments.

By that, I don't mean ownership. Control and guarantees of any form would have the same effect. This gets us back to an even lower layer of inflation causation, which is the question: what social forces, political forces and hence, philosophical forces are creating this governmental process? That question, of course, could keep us here for days, if not weeks. It's the fundamental cause of inflation. The rest of the layers I discussed merely describe the transmission belt through which philosophical values, translated into economic values and ideas, work their way into the financial system which, in turn, has generated the type of inflation now confronting us. Much of the same process exists in other countries. The guarantee process isn't found in the United Kingdom. They put everything in their expenditure budget. But the process is not indigenous to the United States.

MR. HOADLEY: I think that is a key point. You see this same phenomenon all over the world.

MR. GREENSPAN: While this is the basic cause of the problem, it's important for us to recognize that there is a certain threshold of inflation blowoff unique to this country. If we pierce it, we are in very grave economic danger. I would define that threshold as the rate of inflation which is consistent with, or causes, a level of inflation premiums in interest rates which drives short-term rates to approximately 15 percent. I use this number because it will absolutely rupture our huge thrift-institution system. Thrift institutions at this point have longer-term assets whose yields are in the area of 7 percent, clearly far under the short-term money market yields. Thrift institutions can endure a spread of about 200 to 300 basis points before disintermediation occurs. But at a level of, say 7 percent passbook rates and 15 percent short-interest rates, the system will fall apart. By that I mean you'll get huge withdrawals, at which point the Federal Reserve will undoubtedly move in to attempt to shore up the thrift institutions. This, in itself, will rapidly expand the monetary base and, I believe, will make it impossible for us to look forward to using conventional anti-inflationary tactics perhaps for the rest of this decade – perhaps longer.

It is, therefore, incumbent upon us not to pierce that threshold. This is terribly important for the United States, more so than for any other industrial country in the world, because if one defines a breakthrough inflation threshold, it is lower in the United States than in any other major industrial country largely because of our peculiarly American system of thrift institutions – a special type of institution which lends long and borrows short and which can exist in a viable form only in low, single-digit inflationary periods.

MR. REES: Alan, couldn't that dreadful scenario be made a little less dreadful if there were fewer restrictions on the rates the thrift institutions could offer their depositors?

MR. GREENSPAN: No, because it is not a question of Regulation Q, but the financial inability to pay. If the yield on their portfolio is 7 percent, there is no way they can pay 9 or 12 or 15 percent. If one asks why doesn't the Federal Government subsidize them – then what? The size of such a subsidy rules that out. You are talking about tens of billions of dollars.

MR. REES: I'm wondering if we have really reached that point. It seems to me that up to now the institutions have been willing to borrow at the highest rates that the government will permit them to pay.

MR. GREENSPAN: And disintermediation is now in the process of occurring.

MR. GRANT: It is substantial.

MR. O'LEARY: Actually, the present spread between what an average savings bank would be earning and the cost of its money is narrowed down very, very considerably. They have tried to respond. My point is that you can see in the savings banks' figures the very thing Alan is talking about. They have tried to meet this competition of higher rates, but they have narrowed the spread between what they are earning and the interest they are paying. And it is beginning to have an impact on their surplus.

MR. EGGERT: Alan, I am surprised you picked 15 percent. I judge you have given that a lot of thought. I was wondering if 12 or 13 percent might not be . . .

MR. GREENSPAN: No, I was not trying to be terribly exact. But I am pretty sure it's not higher than 15 percent.

MR. HOADLEY: That's the point. Alan is talking about a threshold. I was going to make the observation later that, from a worldwide standpoint, we're approaching the no-return point on inflation with the world average now probably at least 12 percent. It's a very crucial concept Alan has introduced, but it is not an economic concept alone. It is a psychological one, too. In my view, one bulwark in the United States is that the American people, who have not suffered from inflation in the ravaging sense, are still fighting inflation by refusing to pay. This is a phenomenon you don't find in most other parts of the world. There the temptation, in fact the necessity, seems to be to yield to inflation by chasing goods because tomorrow they will either not be available or they will cost more. So Alan has put his finger on a very crucial point.

CHAIRMAN SOMMERS: Alan, you did not state it, although I am afraid I know your answer: Is this process inherently cumulative? That is, unless events intrude themselves on the processes you have described, are there feedbacks in this inflation equation that tend to elevate the rate over time?

MR. GREENSPAN: Well, the crucial variable that is implicit in my discussion, is the inflation-rate premium embodied in the interest-rate structure. That's the mechanism which translates inflation into interest rates, and it is the interest rates, at this moment, which I find the key threshold problem. The inflation premium is, by its nature, expectational. By definition, it is the lenders' expected inflation rates embodied in their supply schedule for funds. So, obviously, the expectational variable moves progressively and cumulatively. In other words, a persistent 12 percent inflation rate is not embodied in an interest rate very quickly; it takes a while. Our studies show that, while we have already embodied a good deal of the most recent inflation in interest rates, there is a substantial amount still to go. So, in that sense, it is a cumulative process, and the longer you procrastinate in coming to grips with the fundamental problem, the worse the problem gets.

CHAIRMAN SOMMERS: One other question. You trace the ultimate cause to the political behavior of the system. But a major mediating element is public spending and the resulting debts, and the rise in the proportion of aggregate debt held in the public sector where the response to interest rates is negligible. Is this consistent with the budget deficits that appear in the record of the federal budget? Because you could argue – and it is often argued – that those deficits are relatively unimpressive when measured against the size of the system, and that the rise in public debt itself, really, has been extraordinarily slow for twenty years. The great growth of debt has been in the private sector. Can this be related to the propositions you have offered us?

MR. GREENSPAN: Yes. First of all, there is no question that the ratio of Treasury debt to GNP and total debt has been going down. But this is beside the point. The relevant process is not the levels but the flows. The level of interest rates is determined at the margin, and at the margin what we are getting, as the second chart indicates (see page 5) is a sharp increase in recent years in the proportion of this type of incremental debt to incremental equity or savings.

MR. WEIDENBAUM: But Alan, didn't you mention earlier the very valid point that, in effect, Treasury debt is a declining portion of the total public sector demand on capital markets?

MR. GREENSPAN: Yes, but the point I wanted to get at is that the critical question is not Treasury debt per se, but total government debt, direct and guaranteed. Anything which increases the inelasticity of demand for the total liability structure of our system increases the pressure on the Federal Reserve Board. Even though the actual unified budget deficits do not look terribly large relative to the size of the GNP, this does not happen to be a relevant comparison. The critical question is control over the utilization of the savings of the system. In recent years, the guarantee programs, which are not in the budget

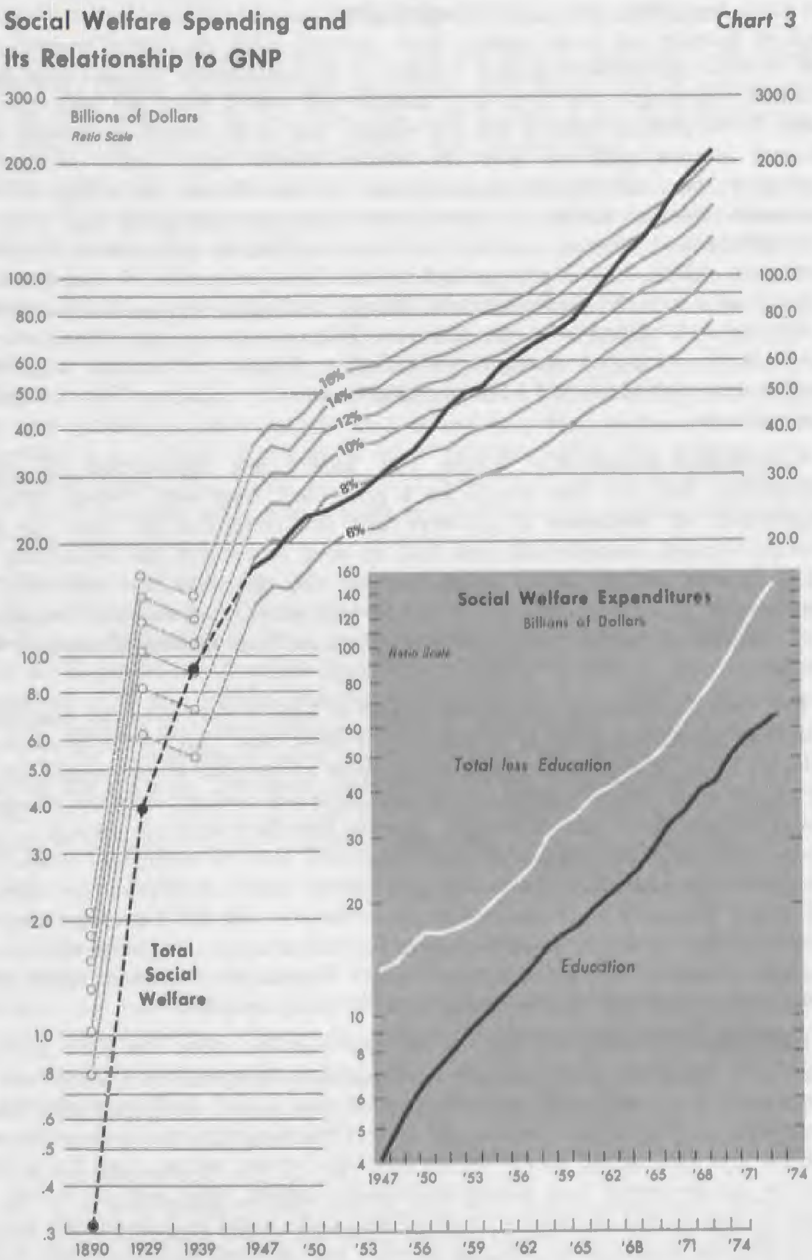
– but which do have precisely the same impact as deficit spending – have been far more important. The critical issue is that, were it not for the fact that the Federal Reserve had to act against high interest rates, the federal budget – or any of these guarantee programs – need not be inflationary, because what such programs are attempting to do is to transfer real wealth from one sector to the other. If the Federal Reserve did not validate any of the private borrowing, and allowed interest rates to rise, the money market rates would effectively reallocate the real wealth or production of our system according to the particular priorities defined by government. One must recognize that it is not even government deficits in and of themselves which are inflationary. It is the process by which they introduce high inelasticity of demand and sharply rising interest rates into the capital markets, forcing the Fed to do something about it. If the Fed were willing to accept 25 percent interest rates, or even 15 percent – I don't know what the number would be – there is no reason why full-employment deficits would have anything to do with inflation. The concept is inappropriate.

CHAIRMAN SOMMERS: Would you accept one emendation to your explanation that the Fed would be a great deal freer with respect to this reallocation of resources if it were not for commitments, such as the full-employment commitment, and that its need to protect the availability of funds to the private sector arises out of the fact that the bulk of the employment is in the private sector and that we have almost ruled out recession as a practical alternative for monetary policy, as have nations all around the world?

MR. GREENSPAN: Al, you know I used to believe that but I am becoming more and more skeptical. It is not that I deny that that is the immediate apparent cause of monetary or fiscal expansion at the time of a recession. But I ask myself what would happen if you eliminated this element from the process? Would it really make any difference? Observe that there isn't a symmetry in the process. For example, do you see any significant fiscal retrenchment when the unemployment rate drops? Basically, you have to question whether the motive which you are ascribing to the process is, in fact, the real one. I am beginning to conclude that the unemployment reasons for various types of policies happen to be more an act of convenience than policy. Governments want to spend and would find other reasons if unemployment were not available.

CHAIRMAN SOMMERS: Let me ask one more question. You have quickly brought us very close to the heart of this problem. Suppose one were to believe that there is an historical tide throughout the world, perhaps very nearly irresistible, in which the demands of society increasingly take forms that are fulfilled by the public sector rather than the private sector. You know this process can be traced back almost throughout history. What you are saying, it seems to me, is that the shift of roles of the public sector and the private sector is unalterably inflationary. Suppose it were our national will to change these proportions, as it is in some kind of dim, unspoken way (see Chart 3). Can such a shift be accomplished *in any way* without massive inflation?

MR. GREENSPAN: Yes. It is done, for example, in a socialist society. One way of looking at our particular problem is that the government wishes to



Note: The parallel gray lines represent the indicated percentages of national output.
Sources: U.S. Department of Commerce; U.S. Department of Health, Education, and Welfare; The Conference Board Chart Service

accumulate, under its auspices, for its own purposes, an increasing share of the product of the economy. However, it is not willing to allow that process to become absolutely clear and unequivocal, either through higher taxation or through higher interest rates. In effect, it is attempting to shift part of the resources from one group to another without the group from whom it is being taken being aware of the process. This is the so-called "hidden tax" of inflation. Now, you ask if it is feasible to implement this shift without inflation? In the Soviet Union it is done all the time. Basically, what you do there is say *this* is what is going to happen. If you don't like it, we are going to send you to Siberia. But here, if you don't like it, you will vote against me, and I don't want that to happen.

CHAIRMAN SOMMERS: Then we are back, really, to essentially an irrational posture in the public sector in which, responding to sociological tides, it is attempting to amplify its control over resources; but it doesn't do it in the direct, overt ways that would avoid the tax of inflation.

MR. GREENSPAN: That is a very kind way of saying it.

MR. WEIDENBAUM: Alan's point about government credit demands being relatively interest-inelastic and, therefore, exerting an upward pressure on interest rates is only now beginning to appear in the public finance textbooks. There is a lag; it is in the few that have come out in 1974. In the latter part of the decade this will become appreciated, no doubt after the key policy decisions need to be made.

MR. O'LEARY: I am a member of the board of directors of Fannie Mae and the new Sally Mae and I can support the idea that there is an interest inelasticity there, a tremendous interest inelasticity. There is just nothing that these agencies can do but go out and borrow the money regardless of the cost. It is, I think, a very important point you make. A shift in that sector means an increase in the whole demand for short-term funds.

CHAIRMAN SOMMERS: We give everybody else one more shot at Alan before we move on.

MR. EGGERT: The only serious question I have is: why wasn't this more evident ten years ago? It just seems to me that you have to give some weight to things like the Russian drought, the effect of the wheat crop failures in Africa and India, and the Arab oil embargo.

MR. GREENSPAN: I would give them some weight, but not very much.

MR. WEIDENBAUM: Ten years ago, the Federal Government, including the agencies, accounted for 10 percent or less of new capital raised. Now it is somewhere between one-third and one-half, depending on what time period and what concepts you are using.

MR. GRAYSON: You have led us right up to the point where you said: here is where it really is. Could you give us a brief idea of what you think are the social forces underlying the desire to create all those transmission belts?

MR. GREENSPAN: Well, Jack, it is best defined in terms of a specific political process of which we are all aware. Anyone who has been involved in a political campaign is acutely aware that, while there is a major problem of special interests in the direct sense – that is, where somebody makes a big contribution and really wants something for it – there is another type of special interest in which the taxpayers' money is involved. As far as I am concerned, these are ethically equivalent. It is the process by which somebody goes around the political stump and promises certain types of cash programs or payments if you will vote for him. It is the new version of giving out chickens on Christmas to gain votes. What has happened is that we have had a mushrooming number of so-called fiscal constituencies in recent times – that is, particular groups within our society who are the recipients of ongoing payments from the federal budget. One could ask, why now? And the reason it is now is that there has been a change in the philosophy of the country. As recently as 1960, the areas over which the Federal Government was supposed to have some control were very significantly limited. It is not long ago that federal aid to education was philosophically anathema. It wasn't long ago that medicare was considered socialized medicine. These were outside the areas where the politicians were allowed to promise anything to anybody. We have now just about eliminated most of the barriers, and everybody is promising everything to everybody.

It gets down to the basic underlying philosophy of a society and the role of government. As recently as 1913, there was a great debate as to whether the Federal Government had the right to tax incomes. It is this approach which is changing. And it gets down very much to one's view, not of economics but of political science – the role of government in our society and the role of government in the economy.

MR. HOADLEY: But isn't there some hope in all this? Wouldn't you say that the days of at least some "promising politicians" are numbered by their inability to fulfill promises? We can go overboard in this doom-and-gloom view. Yet I share a good deal of your concern. Also, I sense a good many people agree without understanding fully what you are talking about. We have seen shortages appearing in this country in a way that we did not believe could ever happen except in wartime. People are beginning to ask, what is this all about? What is happening to our country? I think that is extremely healthy. So, I believe the politician running this fall might get more votes talking reality than a lot of people now think.

MR. GRANT: Walter, I think the problem comes, unfortunately, from the public thinking that the evil is in the private sector, not in the public sector. I have yet to see a top management which could speak to the point and really address itself to the failure of the public sector in competition with the private sector.

MR. HOADLEY: But is the record of the private sector really so poor? Certainly the public record has been shown very recently to be very poor in economic stabilization. I am at least more hopeful.

MR. EGGERT: And the polls show a great criticism of Congress; almost as much criticism of Congress as there is of the President.

CHAIRMAN SOMMERS: We are reaching the point where the question may be: How can *government* get its story across to the people? That would be a nice switch.

MR. GREENSPAN: Let me make just one final point in support of what Walter was saying. You have to distinguish between fatalism and pessimism. I think fatalism, which suggests that there are preordained, irreversible forces, is clearly false. This is a man-made problem, and men can change it. What we have not looked at is what countervailing forces will start to arise as this process intensifies? And I only hope that what Walter is observing are the early stages of forces which tend to be created by the disintegration of institutions.

CHAIRMAN SOMMERS: We turn now to Jim O'Leary on inflation and monetary policy.

Inflation and Monetary Policy

James J. O'Leary

MR. O'LEARY: Much of what I have to say will agree with Alan, although I will approach this question somewhat differently.

May I start by stating a general view about monetary policy and inflation. There is no doubt in my mind that over the past several years an excessive rate of monetary expansion has been a basic and major factor in inflation, but it is not the sole factor by a long shot. I view inflation as a very complicated process. It seems to me that at times during the past several years excessive monetary expansion has been the initiating force. At times, cost-push has been the initiating force. And it seems to have had an existence of its own. The successive large federal deficits have been an important part of the inflation process. Some of the inflation has come from abroad. To begin with, the United States exported a lot of its inflation. But as I see it, foreign central banks are playing the same inflationary game that the United States is playing. So it is not solely a matter of exporting our inflation. Some of our inflation is imported. Accordingly, it is an oversimplification to explain inflation in strictly monetary terms. The inflation we have generated in the past several years is fundamentally the result of an excessive expansion of money, but it is also the product of repeated large federal deficits, cost-push, a disappointing productivity record, and the importing of inflation.

[As background for his comments, Mr. O'Leary reviewed briefly a number of charts depicting, for the period 1966 to 1974, the behavior of several monetary aggregates, the federal budget, and interest rates:

(1) The "monetary base;" (2) Money stock (M_1) – currency in circulation plus demand deposits of commercial banks; (3) Money stock plus net time deposits of commercial banks (M_2); (4) Certificates of deposit of large commercial banks; (5) The "credit proxy;" (6) The behavior of short- and long-term interest rates; (7) Commercial and industrial loans of weekly reporting large commercial banks; (8) Excess reserves and borrowings of member banks; (9) Income velocity of money; (10) Commercial bank deposit turnover; (11) Federal receipts and outlays; (12) Consumer installment credit; (13) Principal classes of loans and investments of commercial banks; and (14) The liquidity ratio of large commercial banks.

In considering the behavior of M_1 and M_2, Mr. O'Leary stressed that he does not believe that they are currently reliable measures of money supply. With short-term interest rates rising to record levels and with stock prices declining, there is a sharp preference for high-yielding liquid assets on the part of investing institutions and the general public, which is reducing the desire to hold noninterest-bearing demand deposits or low-interest-paying time deposits. He argued that a considerable portion of liquid assets rightfully should be included in the money supply. His comments continue.]

Chart 1 is rather interesting. It shows, for the period 1956 to 1974, the behavior of the "income velocity" of M_2 money (i.e., current dollar gross national product divided by money stock). Not shown is the income velocity of M_1 money which has risen from 4.2 to 5.0 since 1966. Chart 4 is based on the more conventional measure of deposit turnover, showing that in New York the annual rate of demand-deposit turnover has risen from 100 to 300 times. We're making money work a lot faster; the effective use of money has increased very sharply in this period. It is more than just a question of the quantity. You can see there is a very, very sharp rate of increase in turnover.

CHAIRMAN SOMMERS: What this chart says is that the average deposit account in the New York area is completely emptied and completely replenished every day, on the average. Is that right?

MR. O'LEARY: Right! It's tremendous! Money is being made to work very, very hard because no one likes to keep cash balances in this situation.

CHAIRMAN SOMMERS: What is clearing today are yesterday's checks.

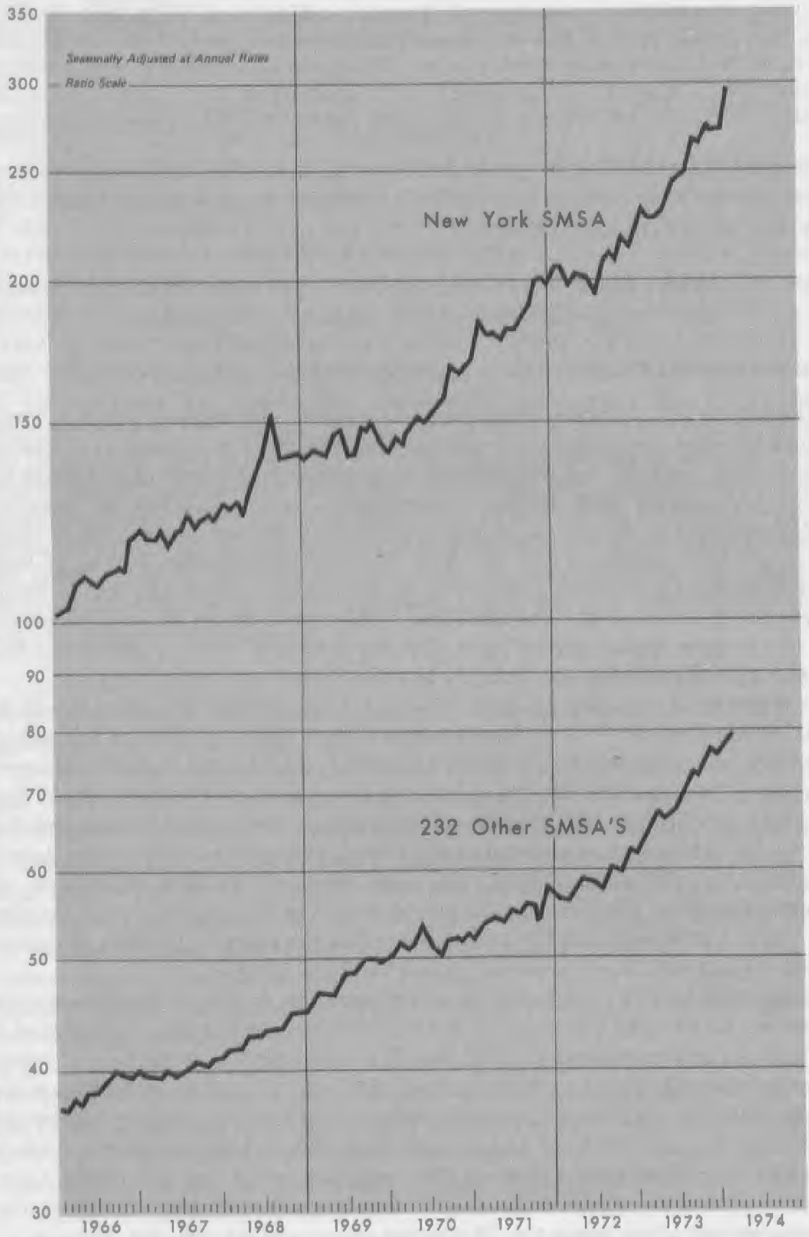
MR. O'LEARY: A rather interesting chart shows the liquidity ratio of large commercial banks in leading cities (page 17). This ratio is defined as: "Liquid assets include Treasury and other securities maturing in one year or less, loans to brokers and dealers and domestic commercial banks, holdings of bankers' acceptances, and gross sales of federal fúnds." You can see in the case of large New York City banks, in the last year or so, a considerable decline in that liquidity ratio. And I think this is one of the constraining forces that is being exerted on the Fed at the present time. I don't mean to be an alarmist about this, but it does appear pretty clear that the liquidity ratio of the banks has declined quite appreciably, particularly in New York City.

To understand the role of monetary policy in the inflation of today, it will be useful, first, to review Federal Reserve policy since 1966. In 1966, as the war in Vietnam accelerated, the Fed recognized the inflation danger that was inherent in a rising federal deficit. Monetary policy became increasingly restrictive in the spring and summer of 1966. Finally, in late summer, the Fed in effect closed the door on further loan expansion through a letter to all the banks. We experienced a liquidity crunch at that time. We went through the first experience of "disintermediation" with the savings institutions. The M_1 and M_2 money supply data, which I reviewed earlier, show that the Fed ran scared after that particular crunch. We had the "mini-recession" of the first half of 1967.

During this period there was a sharp increase in the rate of monetary expansion. All through the period 1966 to 1974, it seems to me, you can find a very high sensitivity on the part of the Fed to the threat, or the fact, of rising unemployment. During the second half of 1967, the monetary authorities seem to have followed a less accommodative policy as the rate of monetary expansion declined. During the first six months of 1968, the Fed encouraged a marked expansion of money supply. During the early summer it began to apply some restraint, apparently recognizing the growing strength of business. Then, in the late summer of 1968, when the 10 percent surtax was put on, the Fed was so sensitive to this situation – expecting that the surtax was going to be a major drag on the economy – that the authorities encouraged an increase in the rate of monetary expansion. By the end of 1968, I think the monetary authorities

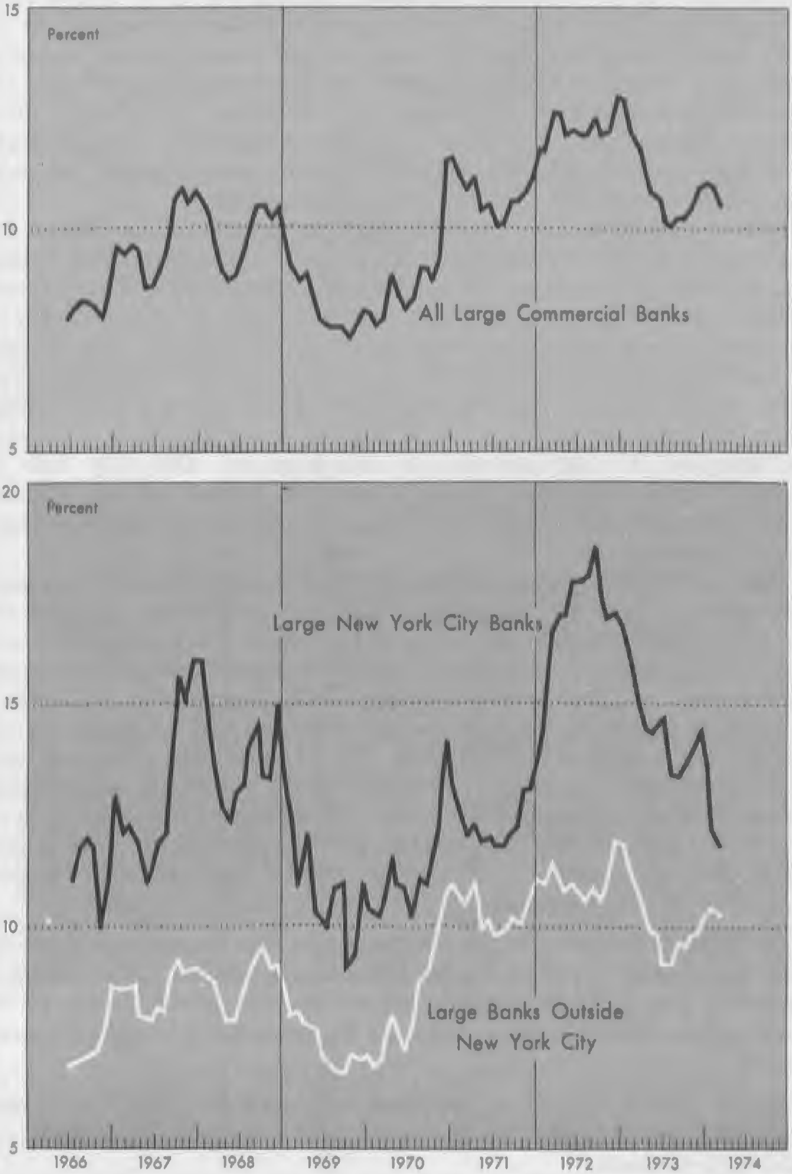
Deposit Turnover

Chart 4



Sources: Federal Reserve Board; The Conference Board Chart Service

Liquidity Ratios of Large Commercial Banks in Leading Cities *Chart 5*



Note: Monthly averages of Wednesday figures. Liquid assets include Treasury and other securities maturing in one year or less, loans to brokers and dealers and domestic commercial banks, holdings of bankers' acceptances and gross sales of Federal funds. Liabilities are total liabilities less capital accounts, valuation reserves, and demand deposits due to banks.

Sources: Federal Reserve Board; The Conference Board Chart Service

realized they had made a mistake on the side of pumping too much money into the economy. They went through 1969 pursuing the policy of attempting to restrain the rate of monetary expansion. During 1969, the annual rate of monetary expansion dropped from 10 percent to about 2 percent. By early 1970, faced with another liquidity crisis, the authorities began to encourage a faster rate of monetary expansion, which continued through the spring of 1971. After a sharp drop in monetary expansion in the second half of 1971, the Fed stepped on the gas again and we had a very strong expansion of money supply in 1972. Early in 1973, there was a marked increase in money supply, followed by a sharp decline in the rate of increase during the summer.

After reviewing the 1966 to 1974 record, my general feeling is that it shows that at times the Fed was an initiating force in the inflation through monetary ease. At other times, the high rate of monetary expansion was, in a sense, simply a validation of the inflation that had already occurred due to increases in labor and other costs. It takes more money at a higher level of prices to do business in the economy. And I think this is one of the stages we are in at the present time.

My general feeling is that throughout this period, as I view Federal Reserve policy, the authorities have been overly sensitive to any slackening in the pace of the economy, to any increase of unemployment. And they have been undersensitive to the basic problem of inflation. I don't say this critically; I realize it is easy to second-guess what they have been doing. But I think history tends to show that.

What are the options open to Federal Reserve policy? At the present time the authorities have very limited options. They must walk a virtual tightrope. Given the double-digit inflation, the economy is calling for a very high rate of monetary expansion to do business – probably about 15 percent. Obviously, if the Fed wants to bring the inflation rate down it cannot permit such a high rate of monetary expansion. But if it squeezes credit too hard it will run the risk of touching off a general liquidity crisis. So the authorities are forced into a longer-run strategy – to exert some "drag" on the rate of monetary expansion, but not so much as to precipitate a liquidity crisis. And they have to be very, very fearful of a liquidity crisis because, as you can see in the banking system and in many other parts of the economy such as the Real Estate Investment Trusts (REIT's), there is vulnerability to a generalized liquidity crisis.

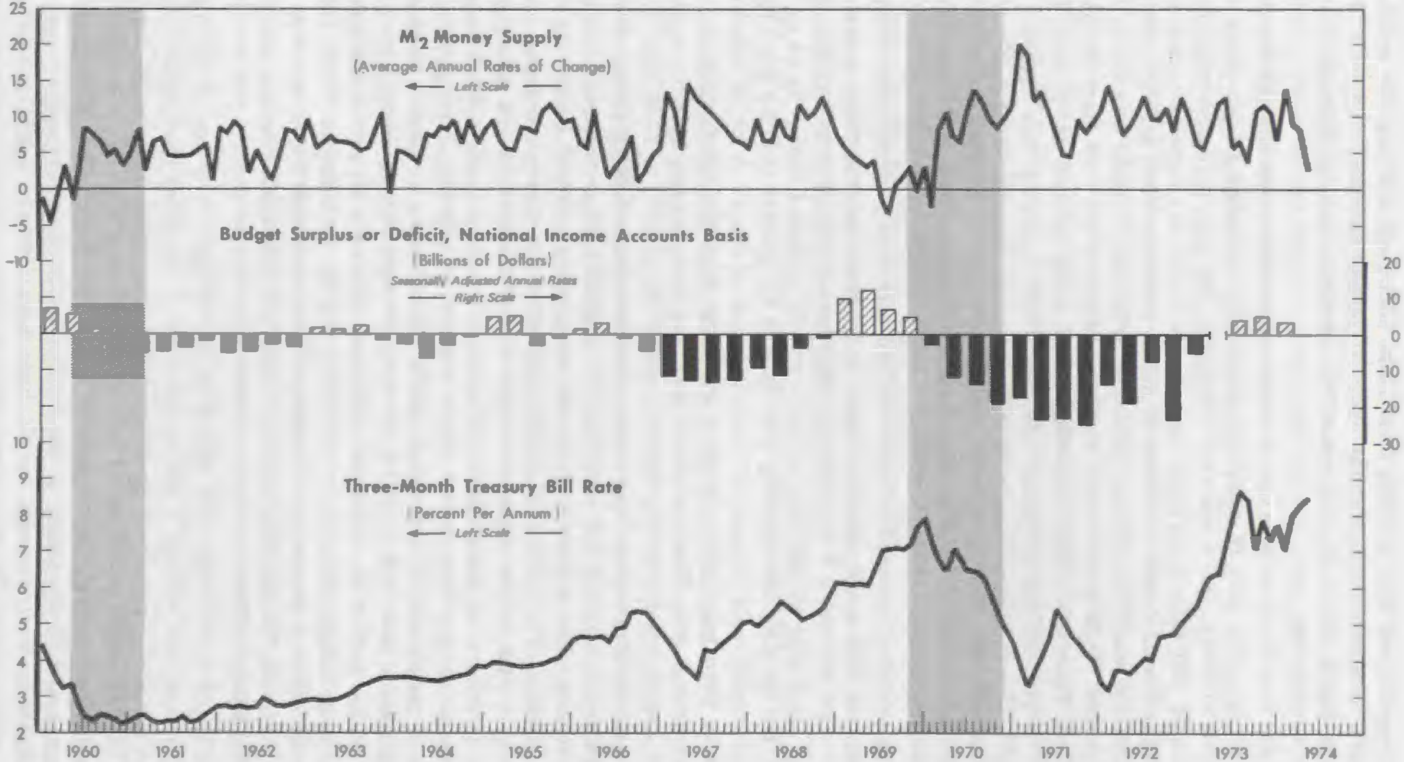
CHAIRMAN SOMMERS: Jim, on that point, the chart you referred us to shows bank liquidity; while it has descended among the New York banks, it does not show a level of liquidity greatly different from the average of the past seven or eight years. Does that chart understate the liquidity problems of the banking system?

MR. O'LEARY: I think it does since that chart is not right up-to-date. I suspect that this year there has been some further deterioration in the liquidity position of the banks.

What can be said about the tools of the Federal Reserve and their adequacy? Generally, my feeling is that the available tools are quite adequate – if the Fed were at liberty to use them – and didn't have the constraint I have noted. I agree with Alan that the authorities can control the monetary base. The difficulty, as I see it, is that they have the tools, but they have political and

The Policy Cycle

Chart 6



Note: M_2 Money Supply includes currency and demand deposits plus time deposits at commercial banks other than large CD's.

Sources: Federal Reserve Board; U.S. Department of Commerce; The Conference Board Chart Service liquidity constraints that prevent them from effectively utilizing the tools. If they wanted to, they could stop the excessive rate of monetary expansion, but they have chosen not to do so because they are afraid they will bring the whole house of cards down.

I would have liked to have seen some use of selective credit controls last year in, let us say, the area of consumer credit. But it seems to me, from the standpoint of today, this is not very important. The volume of consumer credit has declined. But there wasn't any reason in the world why consumer credit had to be expanding as sharply as it was all during last year. Some selective control over consumer credit would have played a useful role, I think. Inherent in the use of general credit policy under these circumstances are very sharp swings in short rates. There is a terrible distortion in the whole interest-rate picture. The roughly 3 percent rise in short rates since last February has occurred in a climate in which there has been a tremendous demand for liquid assets. Just think of how high short rates would have gone if we had not had this great movement toward holding short-term liquid assets. They could easily have gone past 15 percent.

In this period of tremendous inflation, and very strong inflation psychology, we have only had a one percent increase in long-term interest rates. Assuming that investors demand a 3 to 4 percent real return to give up their liquidity, the "natural" long-term interest rate in an 11 percent inflation should be 14 or 15 percent. But the long rate currently is in the 9 to 9.5 percent area. We don't have a natural interest rate because of a combination of events. A lot of long-term funds have been going into real estate mortgage financing, particularly in the income-mortgage area. This year, that market has become soggy because we have overbuilt, and is not demanding funds the way it did in 1972 to 1973. And, even though capital spending has been strong, the total demand being placed on the corporate bond market is not as great as one might have expected, except by the public utilities. The industrial firms are not putting a heavy burden on the capital markets. The private-placement market is not strong. And the other competing market – the income-mortgage part of the market – is not strong. And so you have an unbelievable situation – long-term lenders, such as life insurance companies, have sizeable funds to invest and the demand is not strong enough to push rates up very much. Many life insurance companies are being disintermediated now with policy loans rising. The psychology in the long-term market on the part of the insurance companies, who are a big part of this whole picture, is amazingly different from what it was in the spring of 1970. Then, because of inflation psychology, financial officers expected long rates to go to 11 or 12 percent. Today, they are afraid they will not get their money invested before the market rallies and they see lower long-term rates.

What could have caused that change in psychology? It is one of the most amazing things, and perhaps it will be corrected if the policy-loan phenomenon develops the way it appears to be going. But it is an upside-down world. I think part of the distortion grows out of the fact that more of the country's financing is being directed through the commercial banks. With the removal of Regulation Q ceilings, and with the ability of the banks to go out and bid for CD money, a lot of financing that normally would have gone into the capital markets is staying in the banks. The banks have become more receptive to term loans to business. A lot of financing that would have gone out into the mortgage market and would have been permanently financed is staying in the banks on a revolving credit basis that permits builders and real estate developers to get through a liquidity crisis. So the insurance companies are not seeing the expected volume of private placements and mortgage loans.

CHAIRMAN SOMMERS: Isn't this partly a function of the greatly increased tendency to float the rates on the prime?

MR. O'LEARY: That's right. Term loans are arranged with a floating prime with a cap on them. And business firms prefer to stay in that particular position rather than to go into the capital markets. Institutions that are geared to lend money in the long-term capital markets are not getting the expected volume of offerings. Removal of the Regulation Q ceiling, giving the banks the ability to go out and raise money through the issuance of CD's, was a very important watershed development that has changed the structure of our whole financial system. I was a strong proponent of the removal of the Q ceiling, but I am beginning to wonder whether it was a wise move in terms of the normal channels of flow of funds into the short- and long-term markets.

MR. WEIDENBAUM: How much weight do you give to the weakness of at least some parts of the investment banking industry?

MR. O'LEARY: It probably reduces their willingness to take positions in the bond market.

MR. WEIDENBAUM: And shift it all to commercial banks?

MR. O'LEARY: To some extent.

MR. HOADLEY: It seems to me there are two forces that help somewhat to explain the situation. You have referred to both, but perhaps we might just try to clarify them. The first is that there have been so many predictions of a decline in short-term rates over the last six months or so that it has been prudent for a good many financial officers of corporations to take the floating prime, with all its risks, rather than to lock themselves up into the long-term market.

I think there is also an attitudinal – if you will, a psychological – factor. Not too many years ago, a corporate officer in the long-term market, if he even thought of paying more than 6 percent for 20 or 30 years, was simply ruled out of the boardroom as out of his mind. The fact now is that there are still a good many people around those boardroom tables – who can calculate what the cost of that interest burden is over a long period of time – who don't believe that inflation is going to get out of control. They believe that, for whatever reason, the long rate is going to come down again – if not this year, or next year, then the year after. Take your beating in the short run, and hope and expect some relief there; so, net, you are in good shape. However, there is a big "if": how far can you go in debt relative to your equity? And the hope is that somewhere along the line there will be a rally in the stock market which will revive some long-term equity money at a reasonable cost.

MR. O'LEARY: I think your reasoning is absolutely right. I have no doubt that there is a hope, and perhaps an expectation, on the part of many borrowers that bond yields and mortgage rates will come down from present levels and that it will pay to postpone long-term financing. There is a danger in this, because what seems to happen in a period such as this is that a rising proportion of the debt held by the banks is rather long-term and illiquid in nature. It makes the banking system more vulnerable, and puts a constraint on the Fed. In effect, the Fed must say that we can't wreck the banking system. No, I do not mean to suggest that we are anywhere near the point of wrecking the banking system, but the simple fact is that there has been a significant rise in illiquid asset holdings on the part of the banks.

Suppose the Fed really put the brakes on the expansion of bank credit. What would happen to the work-out situations that exist in connection with the REIT's, which involve a substantial amount of money? I think those work-out situations would be severely jeopardized. In other words, what I am saying is that the movement of business firms into term loans and real estate developers into revolving credits to escape the capital markets severely limits the ability of the Federal Reserve to apply credit restraint in a period such as this without touching off some dangerous liquidity problems. This seems to me to make the banking system more vulnerable to a liquidity crisis on top of other elements in the economy which are similarly exposed. And it then limits severely what the Fed can do. What the Fed is left with, I think, is a long-run strategy of attempting to move through and validate much of this inflation, and then hope that it has time gradually to pull the credit reins in and get down to a lower rate of monetary expansion.

MR. REES: I think there is a pattern in what you are saying that makes sense. You have a situation in which short rates are above long rates; yet a lot of people believe that long rates are too high. The only thing that can make that a sensible view is an expectation that the rate of inflation in the long run is not going to be as high as it has been in the past year. And I think that is a sensible expectation. I agree with what Alan Greenspan was saying: there are some built-in inflationary mechanisms in the economy, and that we are probably not going back to a zero rate of inflation in our lifetimes. I do not see it in the institutional setup of the American economy. On the other hand, that does not mean that we are going to stay at 11 percent forever. The 11 percent reflects a lot of things that have happened in the past year that are one-time events.

Now, what will be the turning point that will start to straighten this out? If we move down to a 6, or a 7, or even an 8 percent rate of inflation – granted those are much too high for the long run – we have made a substantial improvement over the past year. And once you begin to see that substantial improvement, then I think you would also begin to see some turning around in the interest rate structure. If what has been said so far is that we are on the verge of a world in which the rate of inflation is going to be 11 percent from here on out, I would like to dissent. I do not see any reason for being that pessimistic. I think it will turn around.

MR. O'LEARY: I agree with your attitude toward inflation and what might be the intelligent expectation about inflation, but the whole interest rate determination process is more complicated than that. Actually, what you would find among many life insurance company financial vice presidents is the expectation that the inflation rate is going to stay at least as high as it is, and possibly accelerate. There is a lot of that psychology. Now, you might ask yourself why would life insurance investors buy bonds at 9 percent if they have that attitude? The answer is that we happen to be at a conjuncture of events when investors have funds and, at the moment, they cannot get anything better than 9 to 9.5 percent. The money is going out in the face of an expectation that they are probably being pretty stupid in doing this. My feeling is that inflation is a major factor affecting interest rates, but you cannot ignore the basic demand-supply forces in the economy. And the simple fact of the matter is we are going through a period in which the volume of demand for funds in the long-term bond and income-mortgage markets is not as strong as might have been expected. The insurance companies are not seeing the volume of offerings in the private placement area at sufficient spreads, so they are trapped in this situation in which they expect a higher inflation rate, or expect this inflation rate to persist – but they have to put the money out at this rate because that is their only option. One thing that could change this reaction is if, at some point, their cash flow becomes eroded by a sharp increase in policy loans. Then their willingness to put money into the market is going to be changed. Policy loans are going up at the present time.

CHAIRMAN SOMMERS: But the recipients of the proceeds of the loans are attracted into the bond market, perhaps unsophisticatedly. You came close to expressing the view that, in the modern world, perhaps we should be pretty careful about the historical propositions regarding the natural interest rate. There is nothing biblical in the assurance that we are entitled to 3 percent more than the rate of inflation. We are talking about an inflation that is quite different in character, as Alan described it, from the cyclical inflation that occurred in a market economy, which was self-limiting for a number of reasons. There is a logical problem here. We have a different kind of inflation, and the short-term evidence is it is very difficult to find a natural interest rate in the short term. This raises questions in my mind as to whether any long-term investor is well-advised if he sits out waiting for something like 3 percent over the existing, or expected, rate of inflation. He may never get it.

MR. O'LEARY: I will just say one further thing that shows the dynamics of this situation. If we should get a peaking out of short rates, let us say at 12 percent, and then some downturn in short rates, this would probably produce a rally in the bond market, and bond yields would come down. Now as that occurs, there is a lot of money around in trust companies, in banks, and so forth, that is scheduled to go into the bond market – pension-fund money, for example. And that is going to touch off a rally. I don't think a rally would go very far, because I think that then a lot of borrowers who have stayed out of the bond market would go into it. So you could have a short-run decline of three-eighths of one percent or so, and then bond yields would come up again and begin to reflect the basic forces more fully.

I think the whole interest-rate picture is being distorted by inflation and Federal Reserve policy. We ought to have an even greater increase in short-term rates. It has been held back by virtue of the fact that there is a massive amount of money going into short-term liquid instruments and just gobbling up short-term governments, Fannie Mae offerings, Ginny Mae offerings, and all that sort of thing. And there is a distortion which, I think, will ultimately be reflected, particularly in the long rate.

CHAIRMAN SOMMERS: Jim, may I ask one more question? It takes us back a bit. You said that you agreed with Alan that the tools of the Federal Reserve were adequate to this problem. I think you both agree that the exercise of the tools produces very serious problems and wave effects that work their way back very uncomfortably through a political process. My question is: Can you envision modifications of the tools of the Federal Reserve – that is, increased sensitivity of those tools, and selectivity with respect to the consequences of the tightening – that would put the Federal Reserve back in command? What you said, in effect, is that they have theoretical tools, but it is like a nuclear deterrent – their use is a disaster. For example, do you think that the idea of placing reserve requirements against assets instead of liabilities provides such a flexible instrument? Or enlargement of the body of selective controls? Isn't it true that one of the problems of the Federal Reserve is that the exercise of its anti-inflationary weapons kills all of our friends before it ever gets to inflation? That is, it slaughters the housing market, and the state and local governments which, I think, Alan, you would have to agree are rate-sensitive. (In fact, they are subject to usury laws, or to legislative limitations, in many areas.) Right now, the utilities are getting struck. Is there an avenue of escape here through increasing the Fed's powers on the demand side of the market so that they can exercise their authority without killing some of the most socially sensitive parts of the system?

MR. O'LEARY: While everything you say describes the situation, it goes even deeper than that. It seems to me that the use of general credit restraint powers and dependency on interest rates to do the job not only has cyclical disadvantages, but it has longer-run disadvantages. For example, there are insurance companies which have 25 to 30 percent of their assets in policy loans at 5 percent. Now this creates inequities among policyholders. It also erodes somewhat the whole financial position of the insurance company. The savings banks have been squeezed into a position as a result of this in which there is just a very narrow margin between their earnings rate and the cost of their money. The savings and loan associations must have somewhat the same problem. It seems to me there is a process that has been going on which has become cumulative and threatens the successful functioning of all of our financial institutions.

MR. WEIDENBAUM: The point comes earlier than that, Jim. I have in mind things like Penn Central or the Chrysler commercial paper situation, that seem to trigger changes, almost involuntary ease on the part of the Fed, where they ratify inflation. Are the REIT's today's or tomorrow's crisis in commercial paper? Which trigger points, so to speak, is the Fed most likely to encounter?

MR. O'LEARY: I think the Fed, as I read Fed policy, has been acutely aware of the dangers that have existed in the economy – in the REIT's, in the utilities, and even in the banks themselves. The Fed is trying to curb inflation by reducing the rate of monetary expansion, but it must not do so at the cost of a severe general liquidity crisis. And I think this has been a major constraint on what the authorities could do, and they have been well aware of it; I think their policy reflects it.

MR. GREENSPAN: I want to go back to the point you were making with respect to the issue of more direct intervention on the demand side by the Fed. This is an issue which I think will inevitably arise in a somewhat different form because, while I stipulated that I thought the fundamental problem was to bring down the accelerating rate of federal expenditure or guarantee programs, there is obviously another vehicle which can be employed if one seeks to use it, namely, a capital issues committee. This road is potentially dangerous. Once you have a governmental agency passing on who can borrow from the capital markets or from banks, you have, in effect, control over the economy in a far more fundamental way than under price controls. We would be moving very close to a fascist society.

CHAIRMAN SOMMERS: Well, I wonder whether taking such an extreme illustration of additional monetary weapons doesn't overleap a group of more moderate weapons which might permit the Federal Reserve to use its general powers without the nuclear consequences that make it so timid about using them.

MR. GREENSPAN: I may have jumped to an extreme; as a forecaster, I will say there will be intermediate moves. Once you embark upon this process, by its very nature you will eventually push to the extreme. It is just not credible to me that you can start on the road of selective credit controls. You are ultimately going to go directly to a full capital issues committee. Unless, of course, you arrive at the fundamentals of inflation. But the purpose of using that sort of vehicle is largely not to come to grips with the fundamentals. I would expect to hear that we are using it to buy time.

MR. HOADLEY: Famous last words.

MR. GREENSPAN: Yes. No one ever tells me for what purpose.

CHAIRMAN SOMMERS: I note from the questionnaire we all responded to (see page vi), that three of us out of nine – that is, one-third – indicated that selective credit controls would be a desirable device for the further control of inflation in 1974 and 1975. If I sense the comments of the group thus far, this would still be a minority view.

MR. O'LEARY: Let me put it this way. The Fed could say to the banks, as it arbitrarily did in 1966, that it did not want credit expansion beyond a certain point. If the Fed could afford to do that, I would not object to this form of direct intervention. But I do not think it has that option anymore. In this particular situation, I believe the Fed must permit a rather large rate of monetary expansion to take place, and cannot take such an arbitrary position. In terms of the present dangers, it seems to me that using general credit tools is probably the only option the monetary authorities have.

I think we are in the midst of a process in which the rise that has occurred in short rates is beginning to bite into demand. When builders around the country are being forced to pay something like 15 percent for construction money, you cannot say that is not going to have quite an impact on construction. It is also having an effect on retail food chains and other firms where the profit margins are very thin. Although the rise in rates has been taken in stride by Fannie Mae and agencies of that sort, in the private sector of the economy it is biting, and will bite, and will have a real deterrent effect on demand. And another aspect, which I don't think is fully appreciated, is that with the rise in short rates it now costs the banks something like 12.5 percent to raise CD money. And at some point in this process, it gets tougher and tougher for the banks to get a reasonable margin of profit on new loans. Some of the enchantment of expanding loans is squeezed out. My own feeling is that we are probably seeing this process work itself out so that some time in the not so distant future, within a month certainly, we are going to have a peaking out in loan demand and in short rates. At that point, I think there is a good chance that short rates could turn down fairly significantly. So I think the Fed's strategy is the best it could possibly follow. I think it has no alternative. The criticism I would have of the Fed is that it contributed to letting this situation get to a point where there is so little ability to control it.

CHAIRMAN SOMMERS: The minutes of the February meeting certainly suggest that. They are incorporating the rate of inflation into their targets. This is becoming mainly a follower, not a leader.

MR. O'LEARY: Finally, I would like to talk about an incomes policy and fiscal policy as aids to monetary policy and housing policy. I think one of the problems we have had in the past is that, at a time when monetary policy was attempting to cool things down, expansionary housing policies tended to frustrate what the Fed was trying to do. We must have a coordination of policies, not only in the fiscal area with monetary policy, but also housing policy. My view of an incomes policy is that there is a place for it, but only if we have reasonably good monetary and fiscal policies. The wage-price control program could have helped to control inflation – if it had been accompanied by reasonably good fiscal and monetary policies. I would say that no incomes policy is ever going to work if you undermine it with excessively expansionary monetary and fiscal policy. That is the lesson we have learned in the last several years. I'm naturally hostile to the idea of an incomes policy, but do not think we should cast it off forever.

CHAIRMAN SOMMERS: Gentlemen, we will doubtless come back to monetary policy many times. Now for the other wing, fiscal policy, we turn to Murray.

Fiscal Policies and Inflation

Murray L. Weidenbaum

MR. WEIDENBAUM: Alan Greenspan gave me the text for my sermon. He made a statement – if I understood him correctly – "provided the monetary authorities know what the Treasury is doing." It is my observation that this is a very optimistic proviso. You can also extend that to "providing the Treasury knows what the Treasury is doing." Let me give you an example – Jim O'Leary referred to it briefly – the 1968 "overkill" experience. Overkill, we should not forget, did not refer to the tax surcharge alone. It referred to the tax surcharge plus the Congressionally mandated expenditure cuts. But, in practice, the overrun in the uncontrollables – the portion of the budget not subject to the Congressional cut – just about offset the reduction in expenditures in the controllable areas. While the Fed and everyone else outside the budget operation thought we had a tax surcharge plus an expenditure cut, the reality was a tax surcharge, period. You can only question to what extent Fed policy would have been different if it had had better facts on fiscal policy. But if they were different in any way, the result would have been less ease. I think that, perhaps less dramatically, we are in this kind of situation now. I dwell on it because I think it is just another case in point. These are not unusual situations where our factual knowledge of fiscal policy and our methods of analysis are wrong.

Now, I think it is common knowledge, wrong but common knowledge, that the situation facing us for the year ahead is a modest federal deficit which is offset by large state and local surpluses. I think the reality again is quite different from this soothing scenario. If we look at Table 2, I have shown some potential increases from the fiscal 1975 budget. To be fair, the Administration has upped its estimate of the deficit to over $11 billion since I prepared the table. However, I point out that the official estimate of revenues contains $3 billion for oil-tax legislation, which does not seem to be forthcoming in fiscal 1975.

The overestimate in revenues I show as a range. At least the lower end of the range seems, I think, quite reasonable. Now, on expenditures, I have done a little analysis showing the overruns in the uncontrollable outlays by year from fiscal

Table 2: Potential Increases in the Fiscal 1975 Deficit
(Billions of Dollars)

Officially estimated budget deficit	$–9.4
Possible overestimate in revenues	– 4.0 to – 6.0
Possible underestimate in expenditures	– 2.0 to – 4.0
Subtotal, nominal deficit	–15.4 to –19.4
Net outlays of "off budget" agencies	–2.8
Potential "real" deficit	18.2 to 22.2

Source: Murray L. Weidenbaum.

Table 3: Overruns in "Uncontrollable" Outlays
(Billions of Dollars)

Fiscal Year	*Increase from Original Estimate*
1969	$5.4
1970	8.1
1971	9.6
1972	9.2
1973 (estimated)	3.7
Average	7.2

Note: Covers social insurance trust funds, interest, veterans' benefits, public assistance, farm price supports, postal service, military retired pay, and housing payments.

Source: House Appropriations Committee.

1969 through fiscal 1973 (see Table 3). They average $7 billion. The lowest is $3.7 billion, which is in 1973. To be fair, it seems that the overruns are declining as the social insurance trust funds are being indexed. But again, my $2 to $4 billion estimate of overruns on the expenditure side certainly is consistent with the pattern of uncontrollable overruns in recent years. The $2.8 billion of off-budget net outlays will never show up in the budget deficit. Hence, the budget deficit will be lower than my total by that amount, but that, to use technical terms, is a phoney. And we need to nail it as such. These are not the debudgeted or privatized outfits, like Fannie Mae or the Federal Home Loan Banks. These are fully federally owned, federally operated activities, conducted by federal civil servants, whose outlays are financed through increases in the federal debt like anything else. It is just that Congress, in its infinite wisdom, has instructed the executive branch not to include the items in the budget (see Table 4). This runs counter to the notion of a unified budget.

MR. EGGERT: Have these figures been that high in prior years?

MR. WEIDENBAUM: No. That is the fascinating thing. Take the Export-Import Bank, which is the largest item: its outlay was a quarter of a billion dollars in the last year it was in the budget. It is now running over $2 billion a year. That is the whole notion for pulling it out of the budget.

Table 4: Estimated Outlays of Off-Budget Federal Agencies
(Fiscal Year 1975; Millions of Dollars)

Agency	*Amount*
Export-Import Bank	$1,250
Postal Service (net of subsidy)	733
Rural Electrification Administration	598
Environmental Financing Authority	240
Total	2,821

Source: Murray L. Weidenbaum.

CHAIRMAN SOMMERS: Bill Grant temporarily left our meeting to be inducted into the Board of the Export-Import Bank. You can tell him when he gets back.

MR. GREENSPAN: You are saying technically, it is a shell game.

MR. WEIDENBAUM: Amen. I am pleasantly surprised to find myself agreeing with almost everything Alan has said today. Let me nail this myth of the large state and local budget surpluses. There are no large state and local surpluses. No one is looking at state and local budget figures when they make those points. They are looking at the National Income and Product Accounts state and local figures. I have tried to develop the counterpart to the federal budget, i.e., the Census Bureau reports from the budgets of state and local governments (see Table 5). Unfortunately, these are not as timely as the NIA.

Table 5: Two Views of State and Local Finance
(Billions of Dollars)

Fiscal Year	*NIA Surplus (+) or Deficit (–)*	*Census Bureau Surplus (+) or Deficit (–)*
1971	$+2.3	$–4.7
1972	+8.6	+0.3

Sources: Economic Report of the President, January 1974; U. S. Bureau of the Census, *Government Finances in 1971-72.*

But let me say also that state and local decisions are not made on the basis of quarterly figures seasonally adjusted at annual rates. They are made on a fiscal year basis. Hence, in fiscal 1971, when the NIA recorded a $2.3 billion surplus, the Census Bureau tallies showed a deficit of $4.7 billion. In fiscal 1972, which unfortunately is the last year I have available, the NIA showed a whopping $8.6 billion surplus. The Census Bureau also shows a surplus – of $0.3 billion. That is a weak reed on which to hang the notion of large state and local surpluses. Let us also realize that, unlike the Federal Government, most local governments cannot run an operating funds deficit. Hence, you will literally see them laying people off, cutting back services, and still reporting a nominal surplus on current account. So when you get real small surpluses, you know that means fiscal tightness. If you knock out the trust funds, then the state and local governments have been running large deficits.

MR. GREENSPAN: Those trust funds are very much like an insurance company. They are retirement funds which take in tax receipts and invest them in securities. And then, the operating divisions of state and local governments go out and borrow in capital markets. One of the reasons that I get the types of budget figures I do is that I am picking up those gross liabilities.

MR. WEIDENBAUM: And state and local governments have been increasing their long-term debt substantially.

MR. GREENSPAN: I also pick up the accrual basis for receipts, which in a period of inflation gives you an abnormally high accrued surplus.

MR. WEIDENBAUM: As we found out when we were examining the Vietnam War situation, the NIA treats revenues and expenditures differently. It treats revenues with a lead, and expenditures with a lag. In other words, corporate profit taxes are picked up on an accrual basis before the government receives the taxes. But purchases – certainly on the federal level – are generally delivered after the bulk of the payments are made.

In the 1975 budget, we were informed that the federal credit agencies would not be a major factor in the markets for the coming year. Well, I notice Bill Simon's recent testimony on the Hunt Commission report said that FHLB advances, which were at an all-time high of $7 billion last year, will be exceeded this year. This is a good indication of the continued demand by federal credit agencies for capital funds. These data take care adequately, I submit, of the erroneous notion that we have fiscal restraint in the budget.

MR. O'LEARY: Murray, may I just add a quick comment to what you have said. In the last two weeks of March, Fannie Mae was hit with something like a billion dollar request for commitments to buy mortgages. And it is perfectly clear now that this year Fannie Mae is going to be a very large purchaser of mortgages. This whole situation is probably going to put Fannie Mae into a record buying program of mortgages.

MR. GREENSPAN: Which means that borrowing by the federally sponsored credit agencies is going to be larger, not smaller, than last year.

MR. O'LEARY: Absolutely.

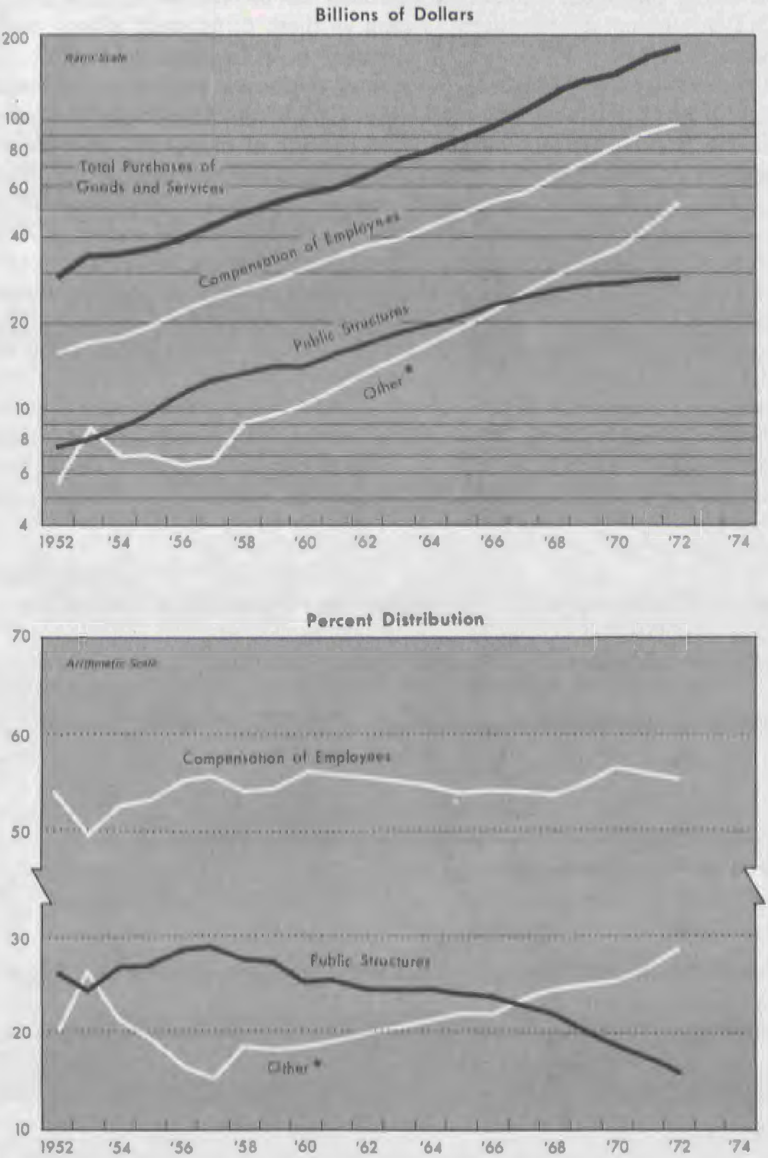
MR. GREENSPAN: And we are talking about double-digit billions.

CHAIRMAN SOMMERS: Before we leap to that conclusion, though, isn't it true that the reason those agencies in charge of supporting housing require all that money is that the Federal Reserve's behavior with respect to the general money market has funneled all the funds out of the private housing financing institutions? And isn't this an inevitable offset to the private funds flowing out of housing?

MR. GREENSPAN: It is offset in a very different way. The Fed would be trying to reduce the degree of elasticity of demand for funds in the capital market in order to bring down inflationary pressures. If, however, you substitute highly inelastic demand, which is essentially what these agencies have, you are defeating the purpose.

CHAIRMAN SOMMERS: I think we have struck a little nugget here, which is worth pursuing. Because if we are pessimistic, as distinguished from fatalistic, on this subject, the plain fact is that this nation is dedicated to a substantial improvement in its housing stock. And those of us who travel a great deal can often see reasons why it should be so dedicated. Now, if our monetary policies are so arranged that housing is the immediate fatality in the pursuit of a reduced rate of monetary growth, in turn in pursuit of a reduced rate of inflation, what other consequence could we possibly expect than that the same political body which is dedicated to housing will then proceed to provide the funds? This

Federal and State and Local Government Purchases of Goods and Services, Excluding Defense *Chart 7*



* Includes equipment (i.e. office supplies), services other than compensation, durables and nondurables goods, agricultural products (CCC).

Sources: U.S. Department of Commerce; The Conference Board Chart Service comes back to the question I asked Jim: Does it make sense to run it this way if we know that those funds are going to be provided in pursuit of a national objective? We are just socializing that industry by pursuing this course.

MR. WEIDENBAUM: May I rephrase the question? To what extent do the differential impacts of monetary tightness set in motion political pressures to offset this monetary tightness, as long as these differential effects are on the kind of borrowers who may be marginal in a financial sense, but not in a political sense? In other words, when small business is pushed out of the market, we get a Small Business Administration. Earlier, the farmers got the farm credit agencies. It is frightening, because each episode of monetary tightness seems to engender another wave of government credit protection. And, as Alan very accurately pointed out, the greater the proportion of credit protected by this government umbrella, the rougher it is for the unprotected segments. And let us face it, we already have a capital issues committee. It just does not cover the whole economy. I hesitate to say this, but, in effect, that is what these credit agencies are. They are a form of capital issues committee.

Having said all this, there are many who say: "Well, fiscal policy really is restraining if you look at it in a sophisticated way; namely, at the full-employment budget." Tables 6 and 7 illustrate my effort to show that the full-employment budget, as presently constructed, has become an outmoded concept. Table 6 really deals with another question, and that is the 4 percent unemployment figure. If you do not believe that 4 percent truly reflects a

Table 6: Variations on the Full-Employment Budget for Fiscal 1975
(Billions of Dollars)

Unemployment Assumption	*Revenues*	*Expenditures*	*Surplus (+) or Deficit (–)*
4.0%	$311	$303	$+8
4.5	299	303	–4
4.8	296	304	–8

Source: Murray L. Weidenbaum.

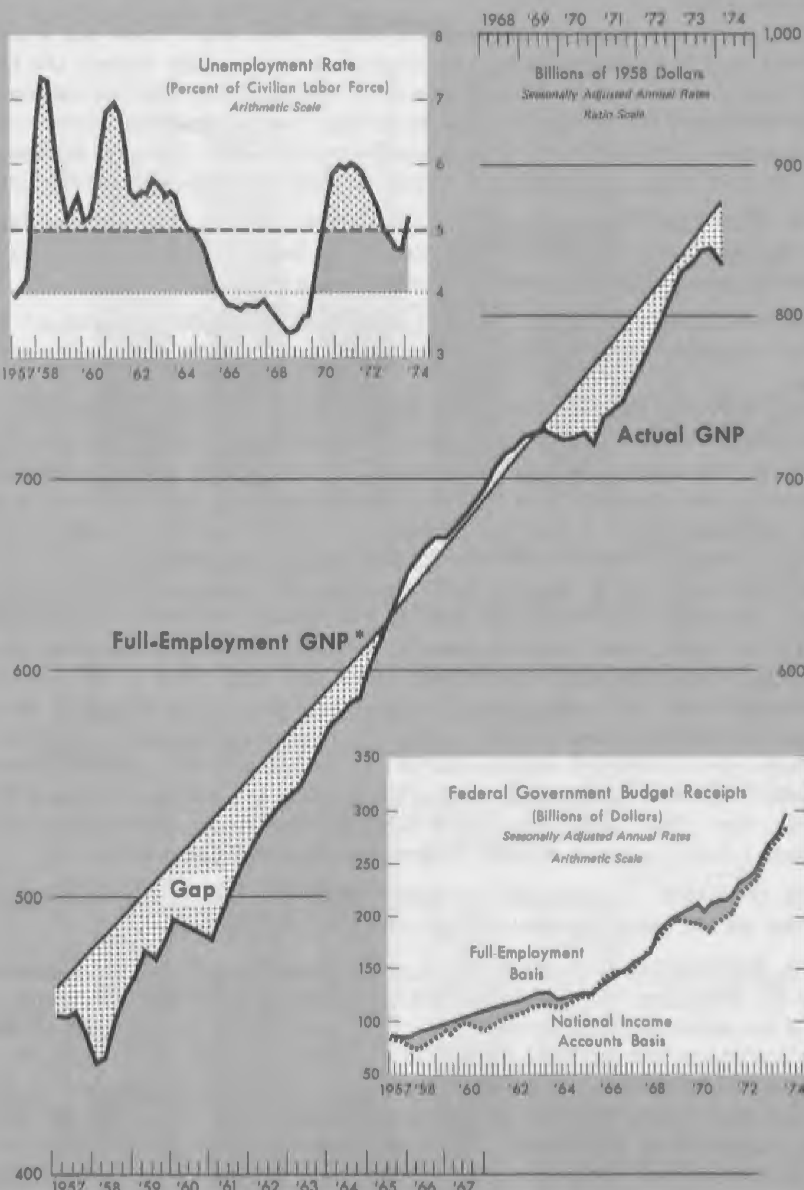
Table 7: Additional Variations on the Full-Employment Budget for Fiscal 1975
(Billions of Dollars)

Inflation Assumption	*Revenues*	*Expenditures*	*Surplus (+) or Deficit (–)*
7%	$311	$303	$+8
3	299	297	+2
0	290	292	–2

Source: Murray L. Weidenbaum.

Full Employment and the Gap

Chart 8



* Trend line of 3.5% per year from I Quarter 1957 to IV Quarter 1962; 3.75% from IV Quarter 1962 to IV Quarter 1965; 4% from IV Quarter 1965 to IV Quarter 1969 and 4% from IV Quarter 1969 to I Quarter 1974

Sources: U.S. Department of Labor; U.S. Department of Commerce; Federal Reserve Board of St. Louis; The Conference Board Chart Service fully employed economy, to the extent that you think it is a higher figure, you get a smaller surplus or a bigger deficit in the full-employment budget than you otherwise would.

The one I really want to emphasize is Table 7. Not that I think that a zero inflation or a 3 percent inflation is a more reasonable figure. Rather, the key point to make here is that the very process of inflation improves the condition of the full-employment budget because, in the short run, revenues are about twice as responsive as expenditures to changes in nominal GNP. Literally, the faster the rate of inflation, the better the budget position on a full-employment basis.

MR. O'LEARY: This is a very important point, Murray. I knew something like this was going on, but I think that table helps one to understand the full-employment budget and the impact of inflation on it.

MR. WEIDENBAUM: And you can just extend my table upward. At 10 percent inflation, we would have an even bigger surplus in the full-employment budget.

Now, I want to discuss the charts on page 35. Chart 9 shows a relative shift to a less savings-intensive and a more consumption-intensive tax system. In other words, the big change has been from corporate profit receipts to social insurance receipts. In the latter case, it is because of an increase in the base and the rate of social insurance taxes. Corporate profits taxes decline proportionately for a variety of reasons, including more liberal depreciation and, more fundamentally, a reduction in the profit share of GNP. However, the Lord giveth and the Lord taketh – or rather the Fed giveth, and the Fed taketh. On Chart 10 we can see the use of those social security taxes to finance a rapid increase in transfer payments, which generate consumption funds and very little in the way of investment funds. So a rising share of the outlay side of the budget is being devoted to increasing demand for consumption goods and services. All in all, I conclude from this bit of analysis that the continued high level of inflationary pressures requires a further tightening of fiscal policy in the United States at the present time. And given the institutional barriers to continued monetary restraint, I think that need is likely to be reinforced in the year ahead.

MR. O'LEARY: I would like to hear Murray's views on the $6.5 billion personal tax cut being proposed by some members of the Congress.

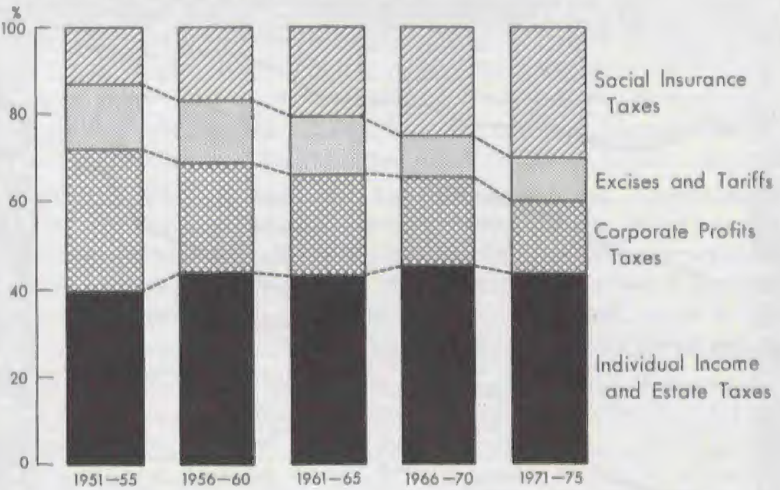
MR. WEIDENBAUM: I think this is most unfortunate. I can see a parallel when the Mississippi hits flood stage and individual neighborhoods get jumpy. It is as if the politicians were saying: "Well, we'll take some of the sandbags off the dikes downtown and put them in front of your house." Some of the most senior Senators, not even those up for reelection or running for President, get on TV and say that inflation is the most serious problem, and you've got to fight inflation by cutting income taxes. I cannot see this having any other effect but reinforcing the Fed's attitude of Hans at the dike, because there is no one else there.

MR. REES: May I comment on that point? First of all, I think we are all being misled by what seems to me to be the most utterly inconsistent set of federal statistics on the economy that I have ever seen. I want to thank my colleague, Ray Fair, for pointing this out to me. It doesn't make any sense at all

Changing Distribution of Federal Receipts

Chart 9

NIA Basis, 1951-1975 (5-year averages)

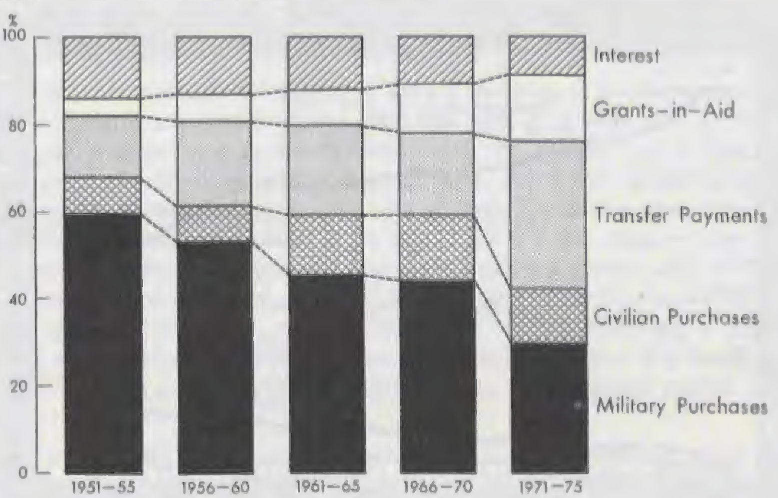


Sources: U.S. Department of Commerce (historical data); Murray Weidenbaum (projected data); The Conference Board Chart Service

Changing Distribution of Federal Expenditures

Chart 10

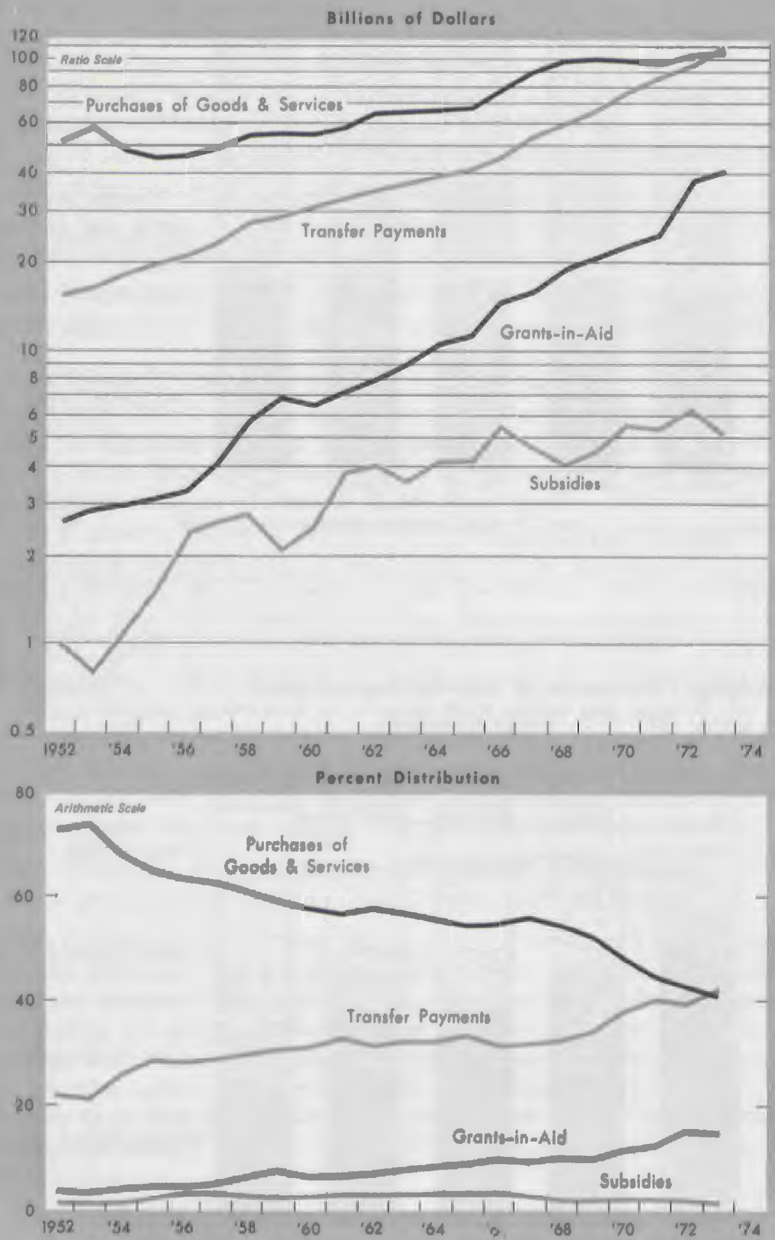
NIA Basis, 1951-1975 (5-year averages)



Sources: U.S. Department of Commerce (historical data); Murray Weidenbaum (projected data); The Conference Board Chart Service

The Anatomy of Federal Government Outlays

Chart 11



Sources: U.S. Department of Commerce; The Conference Board Chart Service to have an unemployment rate that is hovering just above 5 percent, to have the index of industrial production going down only 2.5 percent from its peak month to its trough month, and then to ask us to believe that real GNP went down 6.3 percent in the first quarter of 1974. I, frankly, do not believe that real GNP figure. Something went wrong with the deflators. Somehow you have too many volatile prices in that GNP deflator, relative to their weight in the national economy. I think there is no way, looking at any indices of employment or output, to conclude that real GNP actually went down 6.3 percent in the first quarter. If that is correct, it very seriously undermines the case for a tax cut.

MR. GREENSPAN: I think that is a very good point. I agree with you wholeheartedly that productivity did not go down the way those figures show for the first quarter. One of the major problems is the inventory-valuation adjustment, not the deflator, which affects both the current-dollar and the constant-dollar figures. I do not know what inventory profits were in the first quarter. But I seriously doubt that they were $31 billion at an annual rate.

MR. REES: Now, let me pick up on that. I do not think it follows from that that it would be wrong to increase personal exemptions or minimum deductions. Those are intended to keep somebody who is below the poverty level from paying a positive income tax. And the poverty level is affected by inflation. So I would be in favor of increasing the personal exemptions and the minimum deductions, either on an escalation basis or on a one-shot basis.

MR. WEIDENBAUM: Would you do anything else?

MR. REES: Provided that this is accompanied by revenue-yielding reform in the rest of the structure. I think it would be a particularly attractive package to raise the standard deduction and then take out some of the itemized deductions that are most subject to abuse, like the deduction for gasoline taxes.

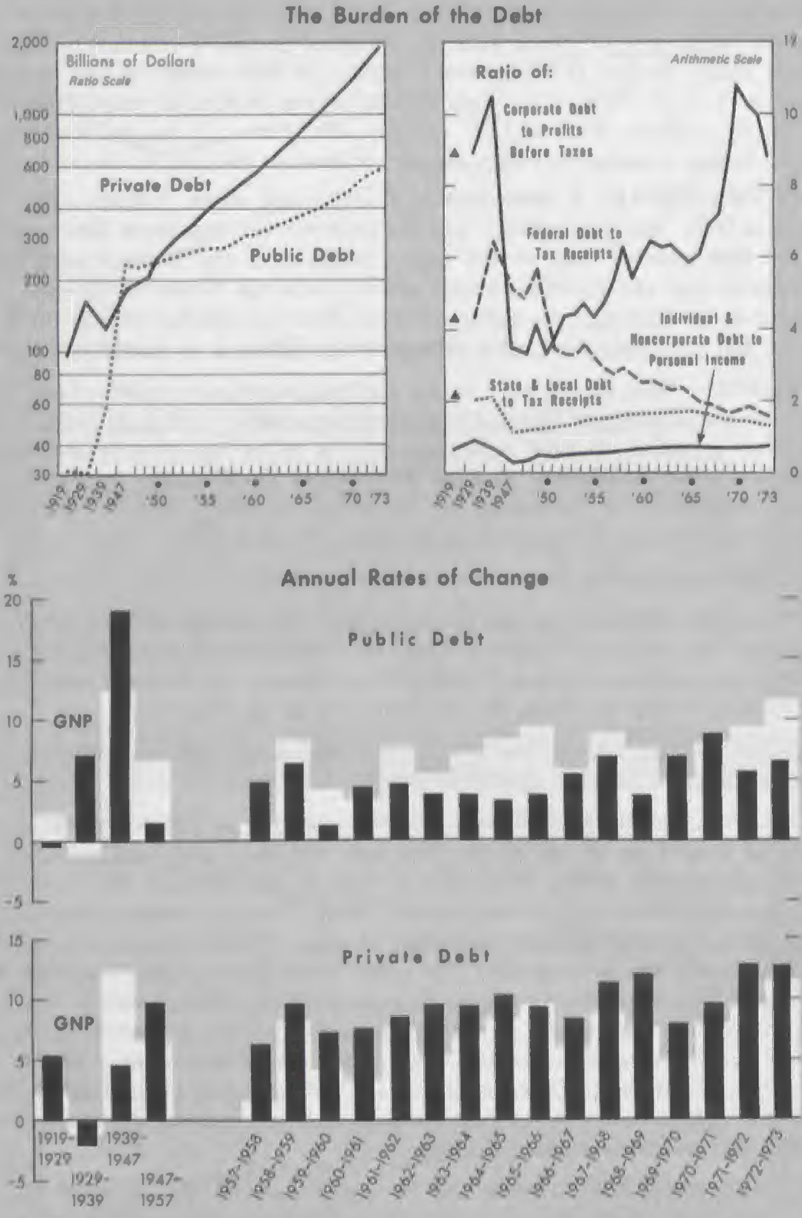
MR. WEIDENBAUM: If you want to help our energy and our environmental objectives at the same time, that is the way to do it.

CHAIRMAN SOMMERS: Murray, I have a question on a somewhat different aspect of this. I am struck by the fact that any chart that puts public debt growth up against private debt growth ends up focusing on the enormous expansion of private debt in the postwar years, and most dramatically in the recent period of rapid inflation (see Chart 12, page 38). Is it correct to point the finger so totally and unilaterally at the public sector under these circumstances? Is it conceivable that this system can operate relatively stably, with little or no growth in public debt, when, after all, public debt constitutes something like 25 percent of the total debt outstanding? I am concerned about a degree of restraint rather ideologically exercised on the public sector. I find it difficult to rationalize such a view with the debt statistics and the incredible private demand for debt that we are experiencing now.

MR. WEIDENBAUM: I think that a major part of the problem is the tendency at the federal level to get around any measure of budget restraint. The old-fashioned administrative budget originally was a very comprehensive document. Then the trust funds came out. Later we shifted to a unified basis and put the trust funds back in. No sooner did we do that when another loophole was developed: the privatization of government credit programs. Hence, we have

Trends in Public and Private Debt

Chart 12



▲ Not available

Source: U.S. Department of Commerce; U.S. Treasury Department; The Conference Board Chart Service

Table 8: The Impact on Credit Markets of Federal and Federally Assisted Borrowing from the Public
(Fiscal Years; Billions of Dollars)

Category of Credit	*1960*	*1965*	*1970*	*1971*	*1972*
A. Net federal borrowing (budget financing)	$ 2.2	$ 4.0	$ 5.4	$ 19.5	$ 19.4
B. Net federally assisted borrowing (financing outside of the budget)[1] ...	3.3	6.8	15.1	18.2	19.2
C. Total federal and federally assisted borrowing (A + B)	5.5	10.8	20.5	37.7	38.6
D. Total funds advanced in credit markets	43.4	69.6	89.0	120.0	145.6
E. (C) ÷ (D)	12.7%	15.5%	23.0%	31.4%	26.5%

[1] Obligations issued by government-sponsored agencies or guaranteed by Federal Government agencies.

Sources: Federal Reserve Board; U. S. Treasury Department.

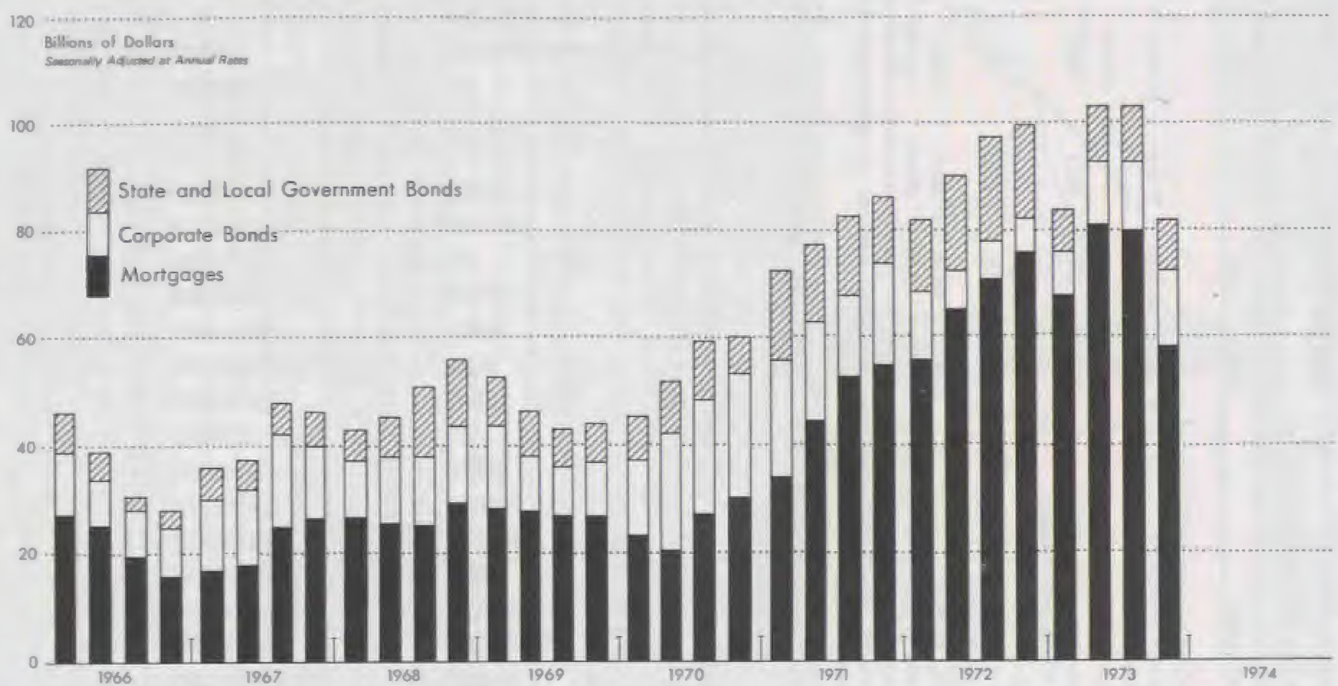
had a massive expansion in government credit programs. I sigh at the figure of a decade ago. In 1960, the federal share of funds raised in private capital markets, using the flow-of-funds data, was about 10 percent; that is: Treasury plus the so-called agencies. And the last year or two, it has fluctuated around 30 percent (see Table 8).

Don't look at the loans extended by Fannie Mae and the Federal Home Loan Banks, but at their borrowing, the protected borrowing. In order to get the figure that one-third of prime capital markets are federalized, you start off with Federal Government's net debt issued: Treasury, TVA, that sort of thing. Then you add in the net debt issued by the so-called privatized outfits – Fannie Mae, Federal Home Loan Banks, and Farm Credit Banks. Those are the major ones. Then you add a third point – the federal guarantees of private borrowing. Add these three together, and that is how you get this massive expansion of the federal presence in ostensibly private capital markets. We talk about the Federal Government being one-tenth of the GNP. When you look at the federal role in capital markets, I say you are getting uncomfortably close to the fifty-fifty point. Keep in mind that every session of the Congress in recent years has enacted still more credit programs. We went from Fannie Mae to Ginnie Mae to Sally Mae to Fannie Rae.

MR. O'LEARY: If you will look at Chart 13, you can see some measure of what Murray is talking about. In the period 1966 through 1970, the net increase in mortgages outstanding amounted to about 50 percent of the total net increase of long-term borrowing in the mortgage, corporate bond, and state and local government bond markets. Since that time, there has been a dramatic rise in the proportion of mortgage debt to the total. In the past two years, the net increase in mortgage debt has amounted to 75 percent or more of the total. What I would

Long-Term Borrowing:
Net Funds Raised by Private Domestic Nonfinancial Sectors

Chart 13



Sources: Federal Reserve Board; The Conference Board Chart Service

contend is that as a matter of public policy, over a long period of time, the vested interests in the mortgage area had been complaining bitterly that they were not getting their share of the long-term financing. What they have succeeded in doing now is, to my way of thinking, creating a distortion through mortgage-backed bonds, through Fannie Mae, through the Federal Home Loan Bank advances – claiming the lion's share of the long-term funds in the market.

MR. GREENSPAN: They are not only getting their share, they are getting everyone else's.

MR. O'LEARY: Let us take the year 1973. The state and local government bond market had a net increase in offerings of about $10 billion. The same thing was true of the corporate bond market – about $10 billion. The total for mortgages as a whole was in the order of $73 billion; of that, nearly $43 billion was on single-family homes; another $9.5 billion on multifamily properties; another $16.5 billion on commercial properties; and the remaining $4.5 billion on farms. So, in effect, what has happened is that institutional changes have forced the lion's share of the long-term capital of the country into the mortgage market. And if in the next ten years the big demand for funds is going to be to finance corporate expansion, these institutional changes are directing money into the mortgage market when very large amounts really ought to be going into the corporate bond market.

MR. WEIDENBAUM: And there are already pressures for government guarantee of utility bonds as a way of dealing with the problem.

CHAIRMAN SOMMERS: Al Rees, you have the floor on wages, the wage-price cycle, and incomes policies.

Wages, the Wage-Price Cycle, and Incomes Policies

Albert Rees

MR. REES: Wage changes for 1973 and through the first two or three months of 1974 have all continued to show a moderate rate of increase. Depending upon which indicator you use, they are in the general range of from 5 to 7 percent per annum. That is, of course, substantially less than the rate of inflation, and the implication is inevitable that wage earners have been subjected to declining real earnings over the past year.

If you use real average hourly earnings for private nonfarm production workers in the twelve-month period that ended with February, 1974, they declined 3 percent. I think that is prima facie evidence that this is not a wage-push inflation, but I don't suppose that is any news to anyone.

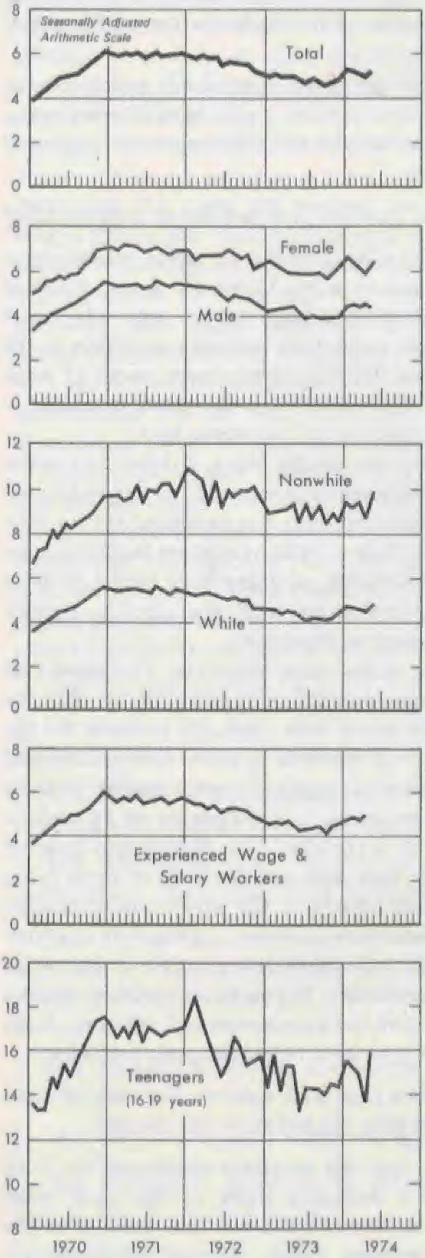
This situation has already changed. It is not yet reflected in the statistics, but with the expiration of wage controls on May 1 – they expired all at once and have not been retained in any sector of the economy – and with union members pressing their leaders for large increases because they are aware of the fact that their real purchasing power has declined in the past year, we are beginning to see very much more substantial wage settlements. I have been following the retail food industry most closely, because I have been involved in wage stabilization for that industry. Some of the major settlements that have been reported in retail food in the last few weeks are in the 10 to 12 percent range. This amounts to increases of 60 to 70 cents an hour, for people whose base salaries are in the $4 to $6 range.

MR. GRANT: Many basic raw material industries are in the 12 percent area.

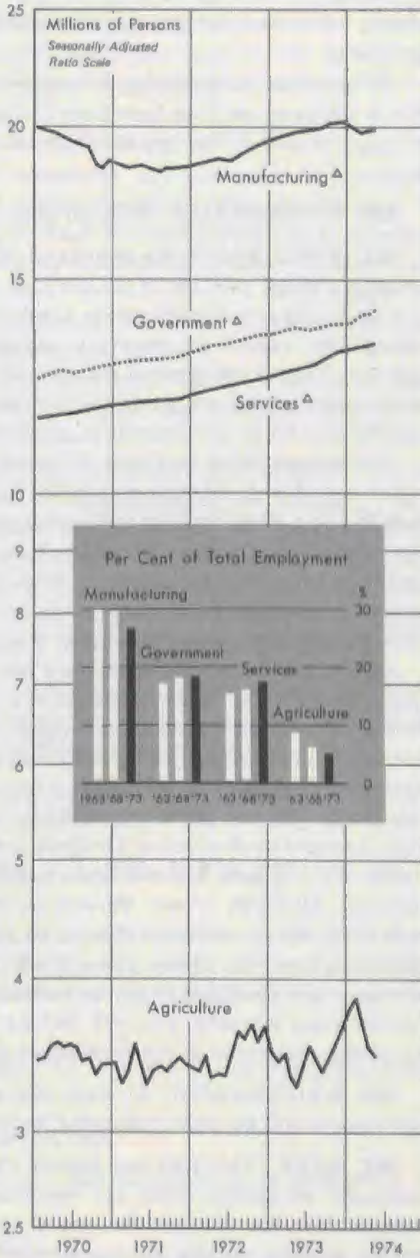
MR. REES: One of the negotiations I would watch most closely, and one I think will probably be among the most expensive wage settlements of the year, is bituminous coal mining. There are two reasons for that: you have a new democratic union leadership, which is going to prove itself just as skilled at the bargaining table as the old autocratic union leadership was; and, secondly, there has been a tremendous upsurge in the demand for coal, and that puts the union in a good bargaining position. So I would expect the coal settlement to go above the average of other recent settlements. The other area which I would watch is industrial construction. Because the Construction Industry Stabilization Committee kept a somewhat tighter rein on wages, I think, than the Pay Board or the Cost of Living Council did, and for a longer period of time, construction unions have been under tight controls for 3 years, in which their wage increases have been in the 6 percent range. In the years immediately preceding that, they were in the 20 percent range and I would not be a bit surprised to see industrial construction rates increasing 15 to 20 percent during the 1974 bargaining season.

Now, that will be tempered a little bit by the weakness of home building. On the other hand, if the iron workers and the operating engineers and the pipe fitters get 15 or 20 percent, then it is going to be hard for the carpenters to

Unemployment Rates



Civilian Employment



△ Establishment data basis; all other series on household basis.

Sources: U.S. Department of Labor; The Conference Board Chart Service

settle for very much less than that, even though they will be working in a somewhat softer demand situation. And so I think we are going to have something of a wage explosion; but notice that the numbers we are talking about, while they are high in absolute terms, are not high relative to the rate of inflation.

All you are really seeing is that we are going to come from a situation in which nonfarm workers have been losing three percent a year in real terms into a situation in which they are breaking even, or maybe gaining one or two percent a year.

MR. WEIDENBAUM: With 20 percent, how do they net one or two percent?

MR. REES: That is the upper end of my range, for the strongest construction unions. I think the 10 to 12 percent range is going to be the norm. I would expect to see a few settlements break out of that range on the high side, but I would also expect to see many nonunion employers not give as much as 10 percent. That is the general picture. We are breaking into a new round of wage settlements which are going to be materially higher than the previous round – and there is no escape from that, given the history of the recent past.

The second thing that you are going to find taking place, I think, is a much wider use of wage escalation in collective bargaining agreements. It has happened already. The New York transit agreement was one that was escalated for the first time this year. Management must, I think, face a choice between building some sort of escalation into long-term wage agreements, or going back to the cycle of annual negotiations or wage reopeners. Confronted with that choice, I think that, by and large, they will choose some form of escalation.

In the private sector, escalation has been less than complete. The mere fact that you have an escalator clause in a wage agreement does not mean that the workers gain one percent in wages for every one percent increase in the consumer price index. There are a number of features in these agreements that prevent full escalafion even with a lag; the most common one is simply to put a cap on it. Say you get a cost-of-living increase up to a maximum of 11 cents a year, or some such number. Or there may be a corridor: you don't begin to get it unless the CPI goes beyond some number, and then you get it up to some other number. All kinds of new devices are being bargained for, and I would suspect that what we are seeing is that in an inflationary economy, instead of a money illusion where you think you are all right as long as you get any money wage increase, you are going to get an escalation illusion. If you get something called a cost-of-living increase, you will feel you have been compensated, but you don't do all the arithmetic to see whether or not you have been compensated fully.

MR. WEIDENBAUM: Al, does this mean that BLS data on the cost of wage agreements will be underestimated because they do not show escalation?

MR. REES: Yes. I do not believe they put the escalator clauses in. So, with increased escalation, they are reporting a declining share of the total wage bargain. But for the past few years, the differences are not that great. For the twelve months ending February, 1974, average hourly earnings of all private nonfarm production workers went up 6.6 percent. Now that figure does have the operation of escalator clauses in it.

The benefits and wages in the first year of collective bargaining agreements, which do not have the cost of living escalators in them, went up 6.1 percent. Maybe if we put the escalators in there, that should be 7 or 7.5 percent. While your comment is correct in principle, I do not think, so far, it has made a very large difference. Obviously, if you negotiate an agreement that does not have an escalator clause in it, you negotiate more cents per hour in the basic wage increase than if you negotiate one that does, and this is the kind of trade-off that people are facing.

One of the gambles here is how rapidly will prices increase? Suppose you are a union, you are coming in for a 3-year agreement, and you ask for 50 cents the first year, 75 cents the second, and a dollar the third. Management says: "I would rather give you an escalator clause. Take 50 cents a year and an escalator clause." Then, if the union is overestimating the rate of inflation, management will be better off with the escalator clause. On the whole, I think people are probably more likely right now to overestimate the future inflation than they are to underestimate it, at least for the next couple of years.

I am not particularly upset by the increasing use of escalator clauses in wage agreements. On the whole, I think it is probably the best way out of the situation in which we now find ourselves.

I don't know that I want to go all the way with my friend Milton Friedman and say we ought to escalate a whole lot of other things in the economy, but I think there is at least one other area that I would escalate. We might offer the small saver, through the Treasury, some sort of an escalated bond. I don't know how the officials of the Treasury live with themselves, putting ads in magazines urging people to buy E Bonds under the current rate of inflation. You would not advise any friend of yours to buy an E bond.

MR. WEIDENBAUM: Well, they buy it themselves, which gives them a stake in the matter. But what would you do with the private thrift institutions, if the Treasury Department is issuing purchasing-power bonds?

MR. REES: A purchasing-power bond would presumably have to carry a very low real rate. Maybe you would get two percent, plus your inflation protection.

MR. WEIDENBAUM: But you start off with a nominal rate that is competitive, and you go on from there.

MR. REES: No, definitely not. I want security for somebody who chooses to maintain the value of the principal and is willing to accept the small real yields, where you would start off with a nominal rate that is well below the nominal rates prevailing in the market.

MR. EGGERT: Would you put a limit on how much one individual could buy?

MR. REES: I haven't really thought about that.

MR. EGGERT: Or would Mr. Rockefeller, just using him as an illustration, be able to buy $5 million worth?

MR. GRANT: We could have an interesting problem of instant national disintermediation.

MR. HOADLEY: The minute you begin monkeying with this savings market,

Growth, Inflation and Unemployment

Chart 15

Sources: U.S. Department of Commerce; U.S. Department of Labor; The Conference Board Chart Service you are starting down the old control road again. When you raise the very basic issue of protecting peoples' capital and savings, at the same time you must also raise the question about what people are holding as liquid assets, and why they are holding them. The discipline of saving is awfully important in itself. If you break the saving discipline by adding a gimmick to it, you may simultaneously create a very serious problem of basic savings erosion.

All kinds of questions come up about what people should do with their money in an inflationary environment. Believe me, this is not a simple subject.

MR. REES: Well, let me comment about incomes policy. I have to confess my biases right away, I am a part-time employee of the Cost of Living Council until June 30, so I may be a little bit favorably inclined to some of the things that they have been doing. I think it was a mistake on the part of Congress to let the Economic Stabilization Act expire completely. I would have retained some rather limited controls in certain areas. I think construction wages would certainly have been one of them. And I think I would have retained some overall monitoring authority; in other words, I would have left an agency called the Cost of Living Council in being, salvaged some of its staff, and perhaps persuaded John Dunlop to spend more time in Washington before he goes back to Cambridge, Massachusetts – rather than just let the whole thing go.

I know, however, from talking to at least some members of Congress, the lobbying pressure for complete abolition of anything resembling controls was intense both from labor and from business. I think I know why. This has been very costly for labor organizations and for businesses in terms of the demands on the time of their executives, accountants and attorneys, and I think they were extremely happy to be rid of the whole thing.

MR. WEIDENBAUM: Isn't the BLS a monitoring agency?

MR. REES: BLS is not a monitoring agency at all in terms of individual pricing decisions or individual wages.

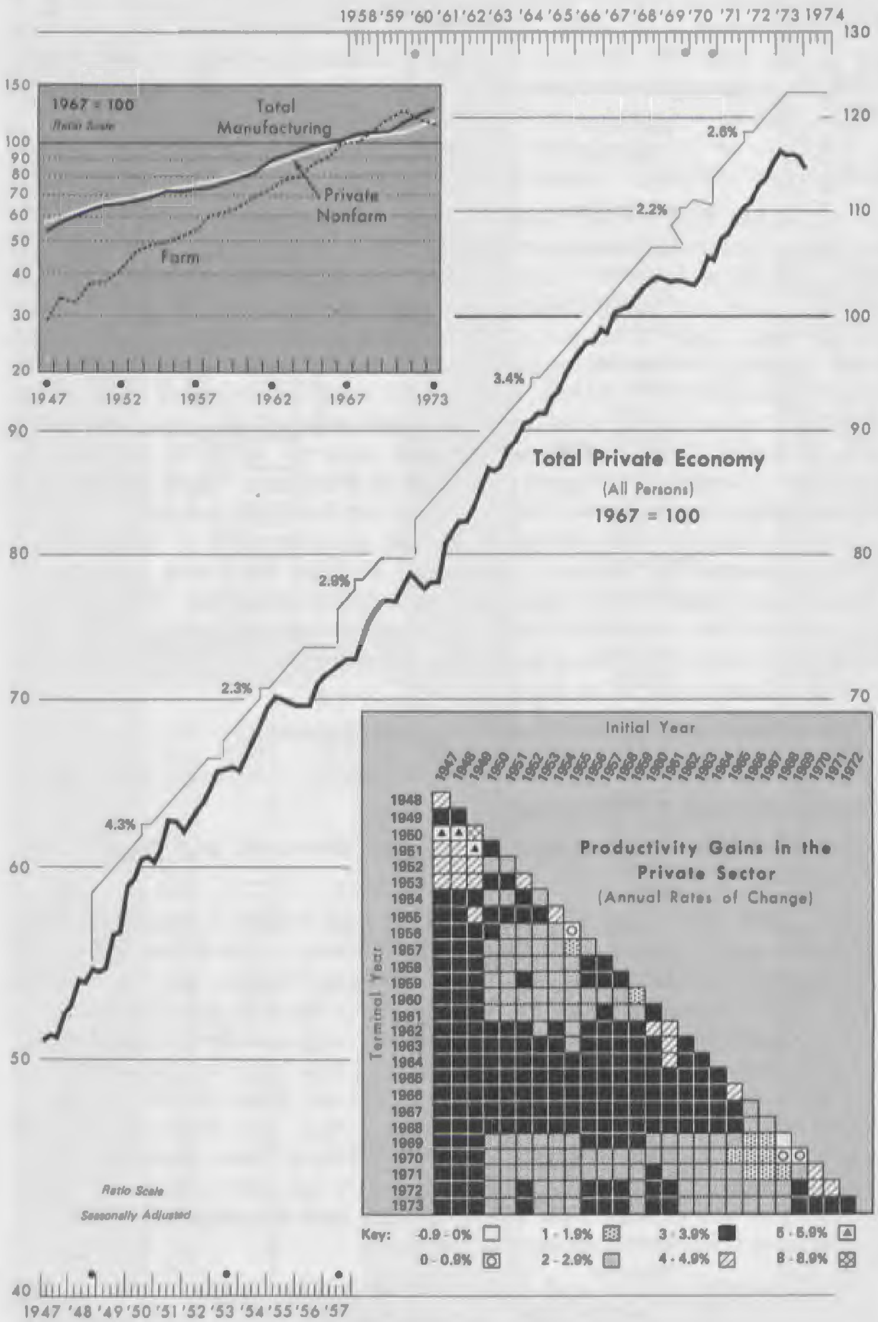
MR. WEIDENBAUM: But there are industry movements. Isn't that what this is all about?

MR. REES: That is not the sense in which John Dunlop was using the term monitoring agency. I guess what he means by it is what, in the Kennedy-Johnson days, we used to call "jawboning." The jawboning function goes back to the Council of Economic Advisers, I suppose, in lieu of anybody else. I do not think it is an agency that is very well equipped to do that particular job, and I would have preferred to see it left in a separate one. I now think we are going to go through a stop-go cycle of the British sort. We are going to have periods of alternating incomes policy and no incomes policy; and when a particular incomes policy gets very unpopular we will abolish it. Then, when the rate of inflation surges up again, we will institute a new one, and always with some gimmick that will enable people to say that this time it is going to be different. And whether it will or not remains to be seen.

MR. O'LEARY: Could I ask you a question which you almost came to but didn't quite? What about the cost-of-living escalators in pension contracts? It is my understanding that in the aluminum settlement there was a limited cost-of-living escalator affecting new pension contracts. Is this going to become

The Behavior of Productivity

Chart 16



Sources: U.S. Department of Labor; The Conference Board Chart Service

pretty generalized? I would expect it would, and it could have some important consequences.

MR. REES: I think unions will be pushing in that direction, and I think some of them do have very real concern for their retired members; and again, we are facing some difficult choices. However, I would much rather see an agreement that says that a person works until age 65 and then he gets a pension, and that the pension is escalated so he has some real income he can count on in retirement. The other route, which I think is much more costly, is to begin to draw a pension as soon as you have 30 years service, regardless of age. Then the individual goes out and acquires a second job. There is a lot of pressure in that direction, too, and I find this much more distressing in terms of ultimate cost to the economy.

MR. WEIDENBAUM: What happens if the unions discover that their pensions are not being indexed as generously as Federal Government's pensions?

MR. REES: I am going to spend next year studying the relationship between public sector and private sector pay. I think we have a bad situation in government sector pay -- much more generally than just in pensions. My suspicion is, and I have not yet begun the research, that governments in general, including state and local governments, are overly generous with their low- and middle-income employees relative to the private sector, and very niggardly with their highly skilled scientific and managerial employees.

MR. WEIDENBAUM: You may pay more, even if you have equality, if your mix is so different that you are comparing secretaries and clerks, which may be a major part of the government labor force and a very small part of the private labor force. So even though you get nominal equality, you may get quite an enriched mix of wage increases.

MR. REES: I don't think so, but there are lots of institutions in the private sector which employ the same kind of personnel as the Federal Government – financial institutions of all sorts, for example. You can make lots of different kinds of comparisons. I would like to compare comparable people, rather than comparable job titles.

CHAIRMAN SOMMERS: Al, you said that you would expect a burst of incomes policies over the next ten years, and you expressed a belief that it would have been wiser to hold on to part of the existing structure. Can I interpret that to mean that you see a permanent role for an incomes policy in the foreseeable future? And that it has a constructive role to play?

MR. REES: I think so, given what you are going to have in an economy in which there are really large aggregations of private power in trade unions, in corporations, in farm cooperatives, and so on. If you were a real purist, a free market advocate, you would say that the right way to go about this is to tear down those aggregations of power and then let the market operate. Politically, I do not see any possibility whatever of doing that and so I think that, short of this, there is going to have to be some sort of regulation. Now we have drawn a very sharp line of demarcation between regulated industries -- like transportation and insurance, or public utilities which are probably overregulated – and things that are not regulated at all. I wonder whether that is a viable mix.

I think in the long run we are probably going to have to free up some of these traditionally regulated things, which have been regulated to death, and at the same time retain some degree of regulation over, say, petroleum companies, which have not traditionally been considered regulated public utilities. I do not think the line of demarcation between a petroleum company and an electric power company is really as sharp as we have made it in our institutional structure.

CHAIRMAN SOMMERS: Apart from the answer you provided us, can we touch upon the question of how you would envision an incomes policy? Your description suggests some degree of mandatory power, or club-in-the-closet device. Do you see *that* as becoming a permanent element in our system over the next decade?

MR. REES: Well, I am not sure that it has to be permanent. I just object to the abruptness of the transition that took place on May 1. I would have gone to some intermediate stage and hoped that, maybe a year from now, you could abandon some more of this. When, or for how long, you would have a period in which there was no such agency, I do not know. I am rather inclined, at the moment, to prefer a permanent agency; but I certainly would have settled for some sort of an interim extension of a much reduced scope of controls and then, a year from now, made the decision: do we still keep something the following year, or do we get rid of it altogether?

CHAIRMAN SOMMERS: Al, do you see the current cycle of negotiations as one in which we can expect a lot of confrontation, or is there a move toward accommodation? And is the settlement pattern used by the steel industry – namely, agreement to settle before the issues become too hot – going to be duplicated by other major industries?

MR. REES: During the upcoming negotiations, I do not see any extraordinary upsurge in strike activity. I think there will be some. I think controls have had the effect of reducing strike activity, because what is the sense of striking if, when you get a big settlement, it is going to be disallowed by a governmental agency? Now you are back to free collective bargaining, and I think there will be some increase in the incidence of strikes, but no more than was normal in the period before controls. Unions are going to press for large settlements and I think, on the whole, management is going to be prepared to give it to them, so I do not see any serious confrontation.

As far as the steel industry is concerned, I think circumstances, for the time being, are unique to that industry. In previous years, as contract deadlines have approached, we have had enormous buildups of steel inventories as consumers attempted to protect their operations through the period of a possible strike. Then, on the other side, you had layoffs and unemployment following the settlement, whether there had been a strike or not. One way or another, these inventories have to be worked off. If they were not worked off through a strike, then they were worked off through a reduction in the scale of operations after the settlement, and that is a pattern that the parties in the steel industry have very wisely decided to avoid.

MR. GRANT: I agree. I think the probability of even a few strikes is relatively low because managements have the ability to pay those increases now in current dollars. Earnings results are far in excess of budgets even with optimistic expectations. So the ability to pay is clearly there.

MR. YANKELOVICH: With regard to that question of whether Al foresaw a permanent incomes policy as a permanent stick in the closet, I wanted to say that from the political side, I do. I think that if we stay on a roller coaster, with discontinuities and maladjustments, the political pressure will go back to something that is tangible and, therefore, politically necessary. It may be that the current response of the public to wage and price controls is that they were too little and too late.

What I would foresee is an interplay between economic wisdom and political pressure gradually finding a meeting ground on some form of incomes policies. It may not be the current one – I mean there is room for maneuver – and in the maneuvering my sense would be that the planning wisdom of the profession would be to try to evolve that minimum form of incomes control that makes the most economic sense. As was said earlier, monetary and fiscal policies may be needed to minimize dislocations. But it is mandatory to have, at least in the planning stage, some conception that can be offered to Congress when the inevitable pressure does build up. I do not know whether it will take one year – or three, or five years. Certainly the abruptness with which the controls have been ended is going to accentuate and add to these pressures.

CHAIRMAN SOMMERS: I think we should turn the conversation over now to somebody who has experienced that abruptness before. Jack, would you give us an inside view of your half of the incomes policy?

Inflation and Free Enterprise

C. Jackson Grayson, Jr.

MR. GRAYSON: I am afraid I have to agree with the prediction that Dan made. I also concur with the scenarios around the table today that inflation will not subside any time soon, and that pressures will build up to "do something." You see it on the floors of Congress; you read it in the polls. And "doing something" means doing something by the central government. It is paradoxical that with government leadership at its lowest rating, people still say: "The government ought to do something."

In my more pessimistic view, I think we are probably in for a series of alternating stop-go cycles. This is what has happened in Europe and in other nations. Progressively, through each cycle, you see a little more centralization of the system, you see a weakening of economic growth and a decline in investment — a gradual winding down of the vigor of a market economy. In the OECD, it is called "the English sickness."

Each time people feel helpless about being able to control inflation, they turn again to some hope that a central government solution can solve the problem. Though the policies may not have worked well before, somehow they want to try them again. I am reminded of the limerick:

> There was a young lady from Kent,
> Who said she knew what it meant
> When men asked her to dine,
> Gave her cocktails and wine,
> She knew what it meant, but she went.

My own view of wage-price controls is that Phase II mainly affected psychology and expectations. That was about all we did. When we had done that, which was in the early period of six to eight months, then we had just about run the gamut of the effectiveness of the types of controls that we were trying to administer. In fact, I recommended strongly that we get out in October, 1972. I saw demand inflation coming. It was clear that the fiscal and monetary policies had turned up the heat and we had better get out of the middle of the road before we were run over.

But we did not get out, and we experienced succeeding Phases. I think we stayed on too long at the fair. If you do stay on, and here is where I am going to disagree with Al and others who are advocating that we have some continuing form of incomes policy, I think you are inevitably led into deeper and deeper interventions into the market. For example, we had return-on-investment controls on the drawing boards. I believe we would have been into such ROI controls in another year because of the equity problems with the profit-margin rule. The profit-margin rule works in the short run only. You end up with fantastic kinds of inequities after a period of time.

Eventually you may feel that you have to let them do this or that in order to get them up to a "fair" rate of return. If you do not do that out of equity, the courts may come in and force you to do it. We were always conscious of the constitutional question of confiscation of capital by inequities generated by our rules. Also, if you argue that interventions can be made equitable by careful firm-by-firm analysis, you do not have time enough for John Dunlop's personal interventions and bargaining with individual units. For such personal diplomacy you would have to have many Dunlops or Kissingers, and I do not think we can, or should, adopt such individual political bargaining in our complex market economy. That makes it a personal political process instead of an impersonal market process.

Once you start intervening in the market process "in the public interest," you are drawn toward the concept of a regulated public utility. The public now has a stake in the total affairs of the corporation, and those who believe in increasing controls over the private enterprise system now have an argument that the corporation should also do X or Y "in the public interest." In other words, once you regulate for very long in the public interest, you begin to assume responsibility for more and more in the name of public interest. That is why I think the steel industry – right now crying for some sort of export controls on scrap in the public interest – is going to get the public interest landing on it in other ways.

I do not think many corporations are sufficiently aware of this when they make trips to the Federal Government for assistance in any form. But I can tell you that legally *and* politically, if you correct an "inequity" which permits a higher return – justified or not – then you are free to regulate in the public interest in other ways. Once you invoke an action in the public interest, you must invoke it all the way.

We are not the only ones faced with such problems these days. I recently attended a conference at Ditchley House in England, which examined the whole question of long-range inflationary biases in societies and incomes policies. There were about 30 people there, mainly from England, Canada and the United States. The group was very pessimistic about the ability of governments to withstand inflationary pressures. The British, particularly, were looking at the political and social trends underlying Alan Greenspan's transmission belts. There was a general feeling that the nations represented there, including the United States, seemed to lack the "political will" to do much about inflationary stimuli that were built into their economies. This applied particularly to unwillingness to take deflationary steps.

There was much discussion about an increasing "social contract," about going back to the medieval arguments about "just wages" and "just prices." We discussed shifting value systems – such as increasing beliefs in cooperation instead of competition, equality of results – all of which are translated into inflation through Alan's transmission belts.

The revival of political economies has been suggested – I think appropriately. In fact, we should utilize the whole field of political science, including looking even deeper at moral and ethical value systems. There may be a predictable time lag between the statement of great ideas and their translation into social norms. We may now be inheriting a philosophy born 80 years ago. I do think we need to look at these factors as much as we need to look at M_1 and M_2 relationships over a period of months or years.

One last point is the question about how the government ought to be involved in incomes policies, if we are going down this path, as some predict. My own prediction is that we *will* be involved in some form of incomes policies in two to three years, if inflation does not cool down.

First, I fear the use of any standby mechanism, such as John Dunlop has proposed, because I do not think that a monitoring agency will be passive or neutral. It will not be just a reporting mechanism. It will be an agency that will take action. The action does not always have to be mandatory price and wage controls. I once asked for a paper in the Price Commission on the techniques of "jawboning." It must have been authored by the Cosa Nostra. There were about 23 methods of jawboning, ranging from gentle persuasion to investigation of tax returns of corporate officers. It was a frightening paper. I buried it. You would not (maybe you would) believe the techniques that are available and have been used, and there's no reason to believe they would not be used in the future.

Knowing that they may be "hit," corporations will be reluctant to lower prices. You say that competition will bring prices down. Maybe. But I feel that everyone will share the same fear and you will get an implicit collusion that none of us had better lower prices.

My opinion is that such a monitoring agency would not be a neutral factor. It would tend to prop up some of the inflationary biases. Also, once you put that agency into being, there will be a group of bright people making great economic studies. My staff was constantly coming up with such papers. Those papers generate a need to act. You can refuse to act, but the pressure is always there to "do something." You really will end up doing something just because you are in existence.

I still see the idea of stand-by controls coming up again and again. I just do not think it is going to be killed forever. In fact, I think you are going to see more and more attempts to form various economic planning agencies around the government.

Look at the report today of Bill Simon, working with a Congressional group to set up a temporary (I laugh at the word "temporary") Commission on Supplies and Shortages. That will not end up being a neutral agency either. It will end up intervening through stimuli on the supply or demand side. This means it will delve into tax questions; it will investigate pricing decisions; it will get into what rate of return we should allow a company if, in the public interest, we give them some advantages to stimulate supply; and so on.

There are suggestions to increase the data gathering and analysis function in the Council of Economic Advisers. I think Senator Percy and others are coming forward with this as a recommendation. I agree with the desire to get better data, but I resist doing more than that – having that agency or any other become more and more of a planning agency. Central economic planning has a great deal of logical appeal because businesses plan. But the two types of planning are not the same. In the first place, the government does not have the data; we do not have the models. Anyway, what really hangs me up ultimately is who supplies the value systems for running that model, even if you have the data and the model?

The closest I come toward accepting any collection of data, analyses and policy recommendations would be the Department of Economic Affairs that the

President proposed about two or three years ago, an outgrowth of the Ash Report. That is a dangerous thing in a way, if it is viewed as being "the planning agency." It will inherit everything I just described. But if you view it as an attempt to collect better data, remove redundancies and inconsistencies, do a better job of making data available to policy makers, then, in this neutral form, I'm for it. Something like that would be better than other attempts to organize national economic activity.

I do think it is important that we have renewed economic leadership in the White House. I am specifically trying to keep Watergate out of the discussion. But no matter who is there, at what point in time, given that economics is now a political consideration in this country, it is of transcending importance that economic leadership be at the top of the government. I do not mean that the President or the senior economic leader has to be an economist, but he does have to take a firm hand in helping to direct the political process to achieve economic goals – which may well be less government.

If this leadership does not materialize, then we are left with a sort of national malaise about where we are headed. This is currently reflected in the polls. It is reflected in the pressure to do something, and such leadership is an important component in being able to keep us *from* doing some drastic things.

At a more fundamental level, I keep peeling back the onion to look for what drives these fiscal constituencies so that everybody is trying "to get theirs," regardless of what it does to others or to inflation. This is the question that was asked at Ditchley. That is where I would like to see some more study.

I asked Alan earlier, suppose you successfully peel back the onion to find out what it is that has changed at the core of our society that makes people demand what they now do of a political process? Suppose you peel back the last leaf of the onion, and you look and there is nothing there? I do not know the answer, but that is one that I am personally going to start investigating.

MR. GRANT: I make one suggestion. Go back and refer to Max Ways' article on the dangers of excess expectations in the May, 1968 issue of *Fortune*. This is a fascinating beginning for what you are talking about and, in my judgment, one of the finest pieces of social, political and economic forecasting. I remember it vividly because of the implications for the stock market – that there was a great degree of excess expectation in security prices. In hindsight we can only say, Amen!

MR. GRAYSON: What generated those expectations?

MR. GRANT: Mr. Ways attributed them to "promises carelessly uttered and moral imperatives that have turned their backs on the virtue of prudence."

MR. WEIDENBAUM: To what extent are we paying a very dear price, literally, for cleaning up the political system? In the old days – you know I am overstating it of course – the spoils used by politicans were jobs at city hall, the turkey at Christmas or Thanksgiving, or whatever. We have cleaned up the political system so that the incentives are not those little, obviously illegal things, but really massive federal spending. So, instead of stealing from the public in tens and hundreds of dollars, we literally take the public for billions of dollars. This is the new spoils system.

CHAIRMAN SOMMERS: Are you sure that it is new?

MR. WEIDENBAUM: Well, it is not really new. What is different is the order of magnitude of expansion. The payoff for politicking for a candidate is not necessarily jobs in city hall, but includes literally multibillion-dollar social programs.

CHAIRMAN SOMMERS: Would you accept a distinction between aspirations and expectations? Expectations are psychological and they can be blown way out of the region of reality to the point where you include everybody above the average income standard. This is a great danger to the system. But isn't the historical trend toward a gradually rising level of aspiration, for society as a whole, in terms of education, medical care, and housing; and how do we organize to achieve those aspirations? Maybe at the root of all this is something more fundamental than just hazy expectations, but a real desire on the part of the population in this country – and in developed countries throughout the world – to live better, to reduce the drudgery of their lives, and to achieve higher levels of intellectual and physical comfort.

MR. YANKELOVICH: I think the distinction is between aspiration and social right. The word expectation is a little bit ambiguous, because on the one hand it implies aspiration, and on the other hand it implies entitlement.

CHAIRMAN SOMMERS: I like that distinction, too.

MR. YANKELOVICH: The psychology of entitlement and aspiration does not cause the mischief. What causes the mischief is the speed with which it is spreading.

MR. GRANT: A great deal of the social violence comes out of these assumptions. Once you define some group's right, if it does not get instant satisfaction they then organize a Symbionese Liberation Army, for example. These are violence constituencies.

MR. REES: I hope we are not saying we do not recognize that there are certain minimum rights that everybody should have by virtue of being part of a society as rich as this. Once you have recognized that, it just becomes a question of where you draw the line, and obviously this line is going to be changing and things that would have been regarded as acceptable 20 or 30 years ago are no longer acceptable.

MR. GRANT: How do we reduce both excessive expectations and excessive consumption? This could be the quickest way to reduce inflation and return some stability into the supply-demand structure. It will take strong economic leadership at the highest political level. For example, look at the lower consumption of electricity since we had just a little bit of leadership from the Administration. Electric power consumption is actually down for the year. Who would have forecast that?

MR. HOADLEY: The basic issue, it seems to me, is not entitlement, or social rights, or aspirations, or expectations. It is what the economy can actually deliver. The ridiculous point here is that we kid ourselves into believing we can go along indefinitely with growth rates that are 6 to 8 percent, or higher. When you compound those rates, you begin to realize that they just are not in the cards. Perhaps the central point is that too many people take for granted all the things that they have, when we have a successful overall economy. Anybody who does not have whatever some other individual obviously has, automatically assumes it is not only his right to have it, but it is quite possible. There is the hang-up – it is *not* always possible.

MR. GRAYSON: Political institutions and the economic logic of institutions are being swept along by a tide that I do not think we really understand. That is where I am searching.

MR. YANKELOVICH: It is one tide for public psychology and another tide for the economy; and they are going in different directions. If there is one single formula that would describe the change of the people's mood over these past ten or fifteen years, it is the concept of looking up from the grindstone. People in every walk of life have told themselves that there must be more to life than making a living, than scrounging and scrubbing away, whether it is doing housework or working at a job. So many of these new concepts of social rights grew out of taking economic well-being for granted. And exactly at the point in history where this is happening, the economy is raising some questions about whether it can deliver the compounded growth rates which this psychology presupposes.

MR. EGGERT: I don't think it's exactly a new thought that human wants are insatiable. That has been around for many, many centuries, so I do not think we are really talking about a dramatically new concept. It almost seems that people want to lift themselves up by the bootstraps and to be right there, above the average, all at once. Is it not then a matter of the degree of emphasis? I think people now feel more intensely about economic differences than they did in the past. This puts a great deal of social pressure on the problem of inequalities.

MR. GRAYSON: It isn't that I don't worry about fiscal and monetary policy, and so on. They are important. But unless we probe deeper, the solutions will be temporary. We are going to be buffeted by the political winds, and pushed by fundamental value systems, the degree and speed of which we really do not understand.

MR. REES: I do not think it is all as new as we are making it out to be. What has happened is that some additional groups have begun to use pressure devices which have been used for decades, and even centuries. Those who have been using them all along are saying: You are invading our territory; we patented that method of getting what we want." I do not believe we are going to be able to hold the line there.

MR. GRANT: I never understood, and was disappointed, when wage and price controls went on in August, 1971. There was sufficient evidence in the spring and summer that such basic industries as housing and automobiles were on the upswing and the CPI had declined sharply from early 1970. The businessman, at that point in time, went along with it as a crutch and yet now complains vigorously about what is happening to him in Washington. Isn't there a lesson here for all of us?

MR. WEIDENBAUM: You look at the data that we were looking at in the summer of 1971, not the data we have now, and the price indexes had turned up again. At the time, there was overwhelming public support for wage and price controls: businessmen writing in urging wage controls, and consumers writing in urging price controls.

MR. HOADLEY: And, I might add, an impending money crisis which indicated, perhaps for the first time, that the dollar was in imminent danger of collapse. Again the feeling was that the Administration had to do something.

CHAIRMAN SOMMERS: On that note, I think, we pause on this issue and switch to Walter and the international area. It is less complicated.

Inflation in an International Context

Walter E. Hoadley

MR. HOADLEY: I must say that I have listened with great interest to the general discussion thus far, but particularly to the repeated references to international developments and influences. Quite properly, we have globalized this discussion in a significant way. I believe we have stated before that inflation has now reached a point where it is so strong and pervasive an international problem that no single nation can solve it, at least in the short run, by itself. And probably in the long run as well.

When we were together at the end of last year, the world inflation rate was in the vicinity of 10 percent, insofar as we could crudely measure it. Worldwide inflation, at least in the developed countries of the free world, now is certainly 12 percent or higher. Most of the difference can be attributed to the Arab oil price increase. Also contributing are some lingering inflationary aspects of shortages of food and commodities in general, plus some other price increases arising out of monetary disturbances and higher interest rates.

We have, for modern times at least, a rather unique situation of worldwide inflation in which every country is importing it from somewhere else, and also exporting it somewhere else. It is difficult to put your finger on cause and effect in order to understand and measure what is going on. Perhaps the most important question is what are the consequences of all this? For the first time I have to say that we seem to be approaching a level of worldwide inflation which suggests there is a point of no return on the horizon; that is, without a fairly severe international economic adjustment. Alan ventured 15 percent as the inflation "break-up" number for the United States. There may very well be a similar number for the world, no doubt somewhat higher.

Having recently returned from a trip through much of Asia, I did not find a single country in which inflation, as locally measured, was less than 15 percent. From Japan all the way down to Indonesia, I found a lot of 15 pluses. Fortunately, there are still a few pockets of moderate inflation, but they are hard to find.

I do not think we are in imminent danger of an international adjustment of serious proportions in 1974, but we are building up to a level of inflation which is going to be awfully hard to get down from without many people getting hurt in the process. At least that is my feeling at the present time. What compounds the problem is something we discussed around this table before; namely, the more or less simultaneous facing of problems of an almost identical nature all over the world. We do not have the law of compensating adjustments, or compensating errors, to help us to the degree that we have had previously. All major nations are essentially in the same boat. The difference is in degree and there is, in my judgment, increased vulnerability for the world economy.

We have talked a good deal already about the political and noneconomic overtones of inflation. Let us just remind ourselves of some of the practical developments resulting from high inflation in recent weeks around the world. It is hard to find a country that has truly stable political leadership. Few countries have not changed their chief executive or ruling group in recent months, or are not in the process of doing it right now, or are not likely to over the months ahead. In no small way, this is the result of the inability of political leaders to keep inflation under better control. Inflation, of course, is not the only factor involved.

We have talked, Jim and others, about interest rates rising around the world. Certainly the evidence is strong that inflation has been built directly into the interest-rate structure for a long time. Accordingly, world interest rates are higher than U.S. interest rates, but the differential has narrowed now. One of the most interesting things is to see how, particularly since the removal of capital restrictions in the United States, worldwide interest rates and U.S. interest rates have come closer together in recent months. Looking ahead for Americans who deal in the world's money markets, we may be approaching an interest rate top on short maturities, if for no other reason than that it is possible now to go abroad and borrow money at a rate not much above what must be paid in the United States.

We have all seen inflation inducing many kinds of speculation. In most cases, land, commodities and precious assets are involved. Money speculation has subsided somewhat, especially because of widely fluctuating rates and some well-publicized losses. But there is a good deal of steam left in speculation.

Fortunately, here and there we can see some declines or leveling off in prices as the result of excesses proving unsustainable. This is heartening because it points to some inflation reprieve, and disheartening because it suggests that some people are obviously being injured. This always happens to those who assume that inflation is going to continue without interruption at very, very high rates.

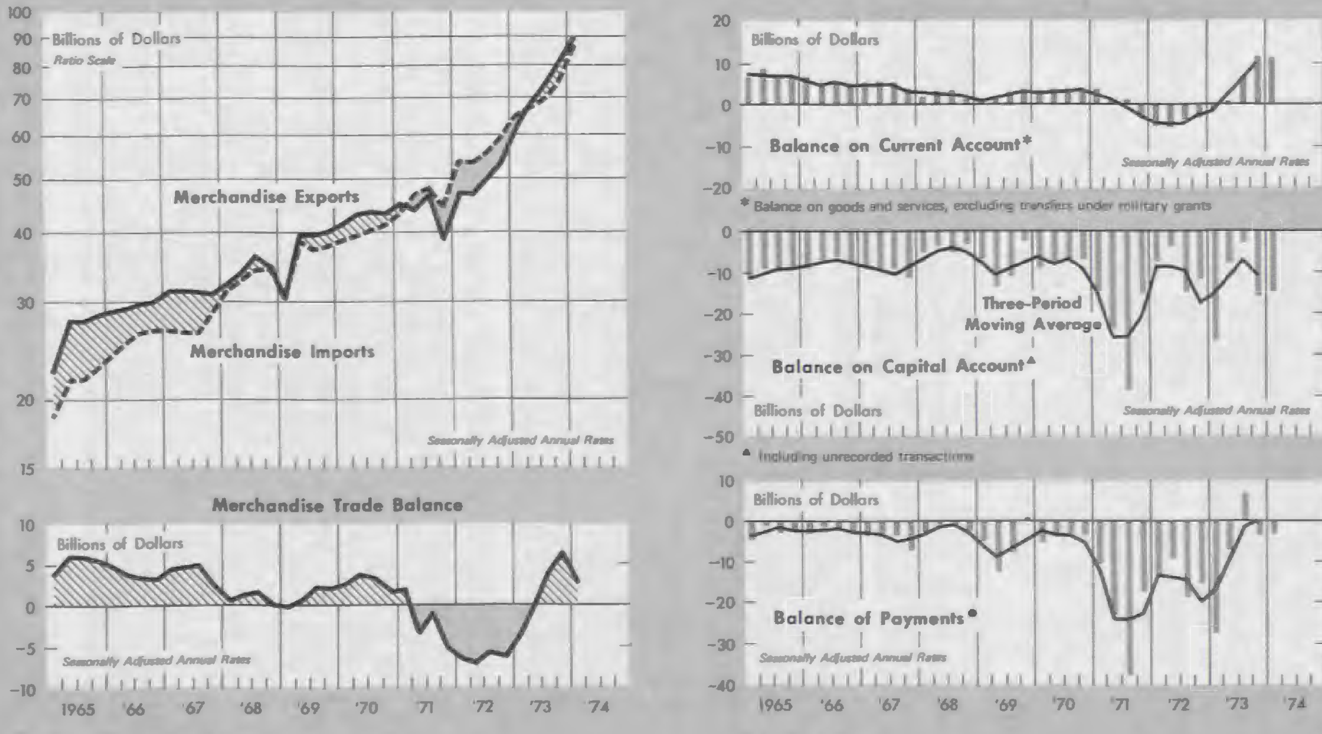
When we include the critical balance-of-payments problems around the world and the inevitable trade and financial repercussions along with high inflation and speculation, we have essentially an unstable world outlook in 1974 to 1975. I would repeat, I do not think we are in imminent danger of a major adjustment, but it seems increasingly clear to me that we are approaching a dangerous inflation range. Unless we confront the reality of this, our country and others are going to be facing more economic and related strains and stresses than we have seen in a long time. The critical task now is to find some kind of new equilibrium in money and goods and get down from the current dangerous level of inflation. It will happen; the only question is whether it will occur in an orderly or in a disorderly fashion.

I do not find any sign of agreement anywhere as to how this will be done by concerted international action. In fact, as a result of inflation, aggravated by new balance-of-payments problems related to oil price developments in the Middle East, the whole case for major monetary reform certainly has to be redirected, if not postponed (see Chart 17, on page 61). Most of the basic principles to be used in trying to overcome the monetary instability of the past are principles which are not operative effectively on a precarious worldwide inflationary base.

I think a prompt and orderly reform, which is probably heroic to expect anyway, is certainly not likely in the foreseeable future. Inflation is simply introducing too many new variables and unresolved questions. Moreover, individual countries are all using about the same techniques to fight inflation, with less and less predictable and desired results.

The International Sector

Chart 17



Sources: U. S. Department of Commerce, The Conference Board Chart Service

We talked about indexing in Brazil, and someone who has been there more recently than I can contribute some comments on indexing realities and limitations before we get through. I am convinced indexing is a gimmick – certainly for the United States – but we may get more of it.

What is happening around the world is that the more pressure put on an economy to restrain inflation, the more interest rates rise, and the greater the political sensitivity, as casualties begin to occur. These include failures of companies, some of them financially related. It has been quite a while since we have heard the wave of rumors of impending difficulties that we are hearing currently. Even this morning, the rumors of failures cover Japan, Europe and Latin America. All this does not reflect major internal difficulties, but it certainly shows symptoms of some acute economic and financial strains and stresses.

The discussion a few moments ago about rights, expectations and other semantics is highly relevant to world inflationary developments. The principal economic and political driving force for years, for decades, has been to put idle manpower, idle resources, and idle capacity to work. Supply, it seems, could always be taken for granted. More demand was given all-out attention. Obviously we are now badly out of balance.

We can not, in a world of essentially full employment, soon realize the expectations of most people. At the same time, the less-developed nations with resources are becoming "have" nations. The very recent experience in the aluminum industry with bauxite is another illustration of what happens when developing nations begin to realize and use their own collusive monopoly powers. Such price increases are certainly not purely economic. We have many new dimensions to world inflation arising out of shortages. These are induced, in part, by new political power rooted in new economic power. But they are also based on a fuller appreciation, worldwide, that growth is not going to be possible without developing a lot of resources that we used to take for granted as readily available.

Recycling of Arab oil payment money has been discussed widely. It has in it both international inflationary and deflationary consequences. The inflationary consequences lie in higher oil prices themselves. As I indicated earlier, most of the increase in world inflation in the last six months can be attributed, in one way or another, to what has happened to oil prices. In the United States, oil price advances have been responsible for at least 1.5 percentage points in the consumer price index. Some, perhaps, would argue as high as 2 percent, or even a little higher when the impact is traced through related markets.

Whatever numbers you use to indicate the adverse balance of payments for oil-consuming nations in order to pay for higher oil prices, you know there is going to be a massive relocation of resources in 1974 and 1975. Herein lie the deflationary consequences. This means a reduction in final demand for a good many products and services in oil-consuming countries. And, of course, there is the closely linked financial question of what happens to the money flowing to the Arabs.

The institutions involved in handling the money are, I think, doing pretty well in projecting an orderly flow for 1974. Borrowing by the oil-consuming nations from banks, special lending programs to be arranged by the International

Monetary Fund, and the drawing down of official reserves seem likely to preserve fairly orderly financial markets for some months, but it is extremely difficult now to see the same conditions through 1975. How such magnitudes, estimated to range from $30 to $60 billion annually, can be handled through normal channels is open to question. This is true either from the standpoint of the oil-producing or oil-consuming nations.

And so there are overtones of both inflation and deflation from oil developments that only confuse the net inflation outlook. Certainly, they also contribute to worldwide strains and stresses. Perhaps the easiest answer is that somebody will lend the needed money. That is a great idea but, in present circumstances, for how long? Another easy answer getting attention calls for an increase in the official price of gold. That particular suggestion is now out on the table in Europe officially, and unofficially elsewhere. To bring the price of gold from its official level up to the market rate – or anything like the current market rate, as defined in London, Paris, Zurich and a few other places in the world – would essentially double the monetary reserves of the world's financial system.

An official gold price increase does not necessarily mean that a new wave of inflation is going to break out suddenly all over the world. Much will depend on what happens to the actual use of the new reserves after they are created. But certainly such an increase would not diminish the potential for a further round of inflation, even during the immediate oil bills-paying period. We have to be prepared, as I say, for more strains and stresses.

The floating exchange-rate structure itself also has had some significant implications for inflation. Floating rates have enabled financial markets to adjust more easily through many more monetary crises than under the old fixed-rate system. In practice, of course, floating is not clean, but managed. It is clear that many nations are holding exchange rates up as a way to fight inflation internally. In short, this mixture of international economic policy and domestic policy means that present floating is not what would normally be expected in the textbook sense.

Now, let us ask how the United States will make out in this inflationary era vis-à-vis the rest of the world? I believe we do have at least one unique advantage. Dan knows more about what I am about to say than I do, but I would like to note the anti-inflation attitude of the American people. Our average citizen is still determined to fight inflation. The expectation in the United States, as far as we can read it among typical individuals, is for more inflation. In fact, there is more worry now about inflation than at any previous time. Yet, Americans as a whole do not believe that the country is going to fall apart because of inflation. Somehow, we are going to solve this problem. Somehow, we are going to bring prices down, and under no circumstances is the average American going to be hurt by declining real income for a long period of time. That is the backbone of the United States' attitude toward the inflation outlook, as we now see it.

This is important because the whole financial system, and the underlying economic system of the United States, are rooted in the belief that Americans will stay pretty much within traditional limits in terms of borrowing, spending, saving and investing. As far as we can track it, there is more ingenuity now being used to avoid paying too high prices, but there has been no major shift, as yet, in the decision to save or not to save; to borrow or not to borrow.

There has been a shift within the decision area of "*how* I should save or invest my money," but not "*whether* I should save or invest my money." Ponder for a moment, a major change in that psychological attitude in this country. Such a change would add an entirely new frightening dimension to the United States economy. Fortunately, the mentality, and that is the right word, in our country now is to fight inflation rather than to yield to it or to try to outsmart it. By and large, the overall world attitude, particularly in those countries which have lived through enormous periods of inflation and correction, seems to be quite different.

Our political leaders might well spend a good deal of time pondering how important it is that we not lose this seemingly unique advantage. In my judgment, we have some time. I wish I knew how much, because we already have a very sophisticated fringe group which has decided inflation is the way of life for the future. But the average American has not yet adopted this attitude.

We do need some important signs soon of price relief around the world to break the chain of inflationary expectations. Fortunately, in commodity areas, we are now seeing some encouraging price cuts. But I think these are not to be taken totally for granted. The marginal surpluses that we may see coming are largely because the world growth rate in 1974 appears to be very close to the U.S. growth rate – one percent or thereabouts in real terms. This is a breather year for the world. Therefore, there is temporarily less demand pressure on markets of all types.

There is no built-in surplus of resources or capacity to permit the world to go back to a 5, or potentially higher, percentage gain in annual real growth. We do not have all the essentials. So, what is the answer to worldwide inflation? It is everything we have been talking about, especially worldwide fiscal and monetary restraints – plus one very practical element. We have to build up the investment capacity of the world in order to have the needed supplies. To improve living standards there must be enough slack so that we do not hit the capacity ceiling and blow our inflationary top every time growth is resumed.

I can see scattered signs of a revival of investment ideas and thoughts around the world, but investors are still wavering. The malaise in this country and elsewhere must be removed. We have the potential for a very significant period of industrial plant and equipment expansion in the United States and across the world, which could occupy political and economic attention positively for several years and postpone the threatened adjustment we talked about.

But if we do not get a surge of vital investment, then we face, in my judgment, a more serious problem lurking on the horizon, because the absence of more supply capacity will only aggravate inflation.

MR. GRANT: Walter, we have talked in the last two meetings about the poor lending practices of the international commercial banking community, spurred on by the typical bank that goes abroad and has to make a loan because the fellow who is there has to defend the high salary and standard of living that he has attained. The difficulty with which the latest billion-dollar loan to a European Community country was put together suggests that *that* may be about the last in a series of such loans. It also may indicate that that is about the last government which is going to raise money on the international world market for some time.

I think someone recently said we are accident-prone, financially. That is much the way I feel, and I can feel very sure in forecasting that Franklin National Bank is not the last one we are going to wrestle with. I hope it is, but logic says otherwise.

MR. HOADLEY: Bill, as you know better than I, ever since the middle Sixties we have had a series of corrective adjustments, if that is the polite word. I do not know where it began, but let us cite as examples railroads, followed by aerospace, security brokers, land developers, airlines, energy-utility areas, automobiles, housing, REIT's, foreign exchange, and retailers. If I understand the comment, you are suggesting that financial institutions, on the whole, are now going through a period of therapeutic correction of some past excesses. Or, at least, questions are now being raised in the field of finance that were not raised earlier.

It would be hard to disagree with this general thesis because the evidence around us shows that there are some liquidity problems for some institutions in a number of countries. This has been aggravated by the oil balance-of-payments problems. What is the answer? If we just make a quick, superficial response to the question, we might be inclined to say we are going to see a wave of financial problems of rather far-reaching implications. But when high-level people are worrying as much as I know they are now worrying, officially and unofficially, about public and private financial problems – including foreign exchange rates and credits – I am inclined to believe that there is less for the average individual to be concerned about. This is not designed to be a Pollyanna answer. The national and international rescue squads are not, you know, totally untrained. The question is, who is to be rescued? From our vantage point, a great many management and government people are searching the financial horizon now for particular problems.

At issue, though, is the basic question of how many can now afford to pay the level of interest rates that is being required by financial markets? Some obviously cannot. I would say, from an international banking standpoint, that more energy is being given now to rechecking credits – and more people are flying across oceans trying to consult to make sure that financial and monetary fundamentals at least are not in jeopardy – than in a long time – or ever. Fighting inflation by current methods means some more people are going to get hurt, and some institutions as well. Speculators, the unlucky, and mismanagers are usually the ones who are shaken out in this type of financial squeeze.

What concerns me, as it must concern you, is when broad questions are raised about the field of finance. There are always more overtones of severity and importance when they are raised about finance than about some other fields. That brings me back to some fundamental questions. How strong is the U.S. economy? How strong is the American dollar? How strong are American-dollar institutions?

From every aggregate statistical or other economic viewpoint that I think you and I could agree on, there is still an enormous amount of strength on all scores. Therefore, once again, let me say that I do not feel that we face an imminent major adjustment problem. Nevertheless, it is absolutely clear that when inflation is as high as it is now, interest rates are so high, and money very expensive or tough to get, people in danger of being overextended had better crawl back and get liquid – while they can.

MR. GRANT: I guess I would remain much more comfortable if the leverage in the commercial banking systems was a lot lower, if they had more equity, if I really felt that the adequacy of their bad-debt reserves was at least a comfortable one and certainly, informally, some bankers say it is not. Formally, everybody says it is fine, but I have an uneasy feeling about what is happening to lending practices throughout the world. Again, you know, it is the kind of thing you cannot prove until it has all happened, and then you say, well, it was there all the time.

CHAIRMAN SOMMERS: I have a more general question – how would you spell out the resulting consequences if the United States were to struggle to achieve, and did achieve, a rate of inflation that was considerably below that prevailing in the rest of the world? In other words, is that a soluble problem, or does it set in motion forces that become self-defeating?

MR. HOADLEY: Well, it certainly is desirable for all concerned for the United States to fight inflation. If the United States gives up the battle against inflation, then obviously the world is in real trouble because major currencies and economies are tied to the dollar. The United States must, in its own interest and in the world interest, continue to fight for the lowest rate of inflation possible.

Having said that, though, let us follow through the consequences if the United States were actually to win the domestic battle against inflation. In such a case, the American dollar more than ever would have a position of enormous strength. Moreover, unless we embark upon a new set of controls, there would be tremendous world interest in the American dollar and a new inflow, that is, a return home of dollars. This would have an initial effect of driving up the demand and price for American products, obviously putting more pressure on the already essentially fully employed economy. Success against our inflation would compound our inflation problem all over again.

Here is an important reason why I have said all along that the United States, or any other major nation, cannot by itself now solve the inflation problem for long without having to face the consequences of its very success.

CHAIRMAN SOMMERS: What I hear you saying in a way is that, if we were to solve our price inflation problem at home, that may not solve our interest-rate problem. Would that be correct?

MR. HOADLEY: That could be one of the results.

CHAIRMAN SOMMERS: If the rate of inflation goes down, the dollar becomes an attractive repository because of its stability. On the other hand, if our interest rates go down, our short-term funds would presumably go out in search of higher rates elsewhere. Where does that balance leave our interest rates? It almost seems to me that, in part, our interest rates reflect world inflation, not just domestic inflation.

MR. HOADLEY: That is right, Al. You are saying, in effect, to expect some enormous crosscurrents. In other words, if dollars come home and interest rates go down, then some money will again go where rates are higher.

CHAIRMAN SOMMERS: Dollars come home for safety; they go out for yield.

MR. HOADLEY: For example, on a given Tuesday morning dollars could be moving one way, and they could be moving the other way on Wednesday. This would be, at times, a highly unstable situation, but the net of it is that the future of the American dollar, in my judgment, fundamentally is tied to the real performance of the American economy, especially performance on the inflation front. Clearly, the risk factor in financial decisions will be more important than the yield factor in a period of intense financial strain.

MR. REES: Walter started out by pointing up the fact that we do have floating rates. They are not a clean float, but a managed float; but at any rate they are a float. In the discussion about what happens if we have less inflation than other people, you left out the mediation of the exchange rate, and it seems to me that changes the story. There will not be the same situation there was the last time the dollar was an attractive currency, because the price of the dollar will go up vis-à-vis other currencies, and that is going to contain the inflow. I am not sure that you are going to get quite as massive a rush into the dollar as you would have had the dollar been fixed in relation to these other currencies.

MR. HOADLEY: Let me back up for a minute. Obviously, we have to make some assumptions about what will be going on at the time. If the rest of the world is peculiarly unsuccessful with inflation, then the imminent worldwide adjustment will become truly imminent. The rest of the world presumably would be a less desirable place to invest money. This is the lurking fear of a good many observers overseas. They frequently say: "Well, whatever may be wrong with the United States – from Watergate to what-have-you – nevertheless, when the chips are down, *there* is where I want my investment." This overseas scenario says to move toward the dollar because of worse problems at home.

But there is another side. The mere fact that there have been rumors in recent weeks that the deutsche mark will be revalued has made the dollar a weak currency. The question is not do we have floating exchange rates, but what kind of floating? Also, at what point will the Germans decide to cast themselves loose from the Common Market exchange system? If we had a theoretically perfect floating arrangement, then many continuing monetary problems might disappear. But we certainly do not live in a theoretical world. The concept of floating rates has come through reasonably well in actual practice, but it is not the answer to a new monetary system.

When political uncertainty and other questions about changing political leadership are considered, you cannot be sure that some financial markets will not fall apart again. The worst fear in international financial markets is competitive devaluations. But offset against all this are thousands of high-placed financial leaders throughout the world who are talking to each other regularly. They are continually evaluating alternative courses in a perfectly ethical and legal way, because they do not want a large-scale economic-financial bomb to go off.

Perhaps all we need say is that the United States must work very hard to contain inflation. But by doing so it will not necessarily bring interest rates down on any permanent basis for us. As Bill points out, the massive demand for long-term money could remain very firm – no matter what happens to short rates.

MR. EGGERT: Walter, I've heard you say it and I have argued for some time that we need to rebuild supplies of scarce items. You may recall many debates about agricultural programs. Most economists took a very dim view and argued this was the wrong way to go. We have to say we are fortunate to have had such fairly full bins when Russia had the failure. Inflation, food inflation at least, would have probably been much worse without them.

But I would like your counsel on who should own the supplies. One could argue that private enterprise – companies, individuals, farmers, and so on – own them. But then you get into the whole question of how they are financed and what these high interest rates will do in terms of whether individuals can *afford* to own these supplies. Have you given that a thought? You did bring out the point that there is a need to rebuild supplies. I think one of the things we are faced with here, as a nation, is to make the decision in the next two years as to who should own them.

MR. HOADLEY: I would not propose a massive government program to build up stockpiles. I concede that here and there, for some defensive or strategic reasons, temporarily and selectively our country might very well do this again. My plea would be, however – and I think this is what Jack Grayson had in mind too – to take a hard look at what the return on investment would be. Why are these needed supplies not readily forthcoming? In many cases the reason is not at all clear to the public. The problem, particularly in recent years, has been that there was no way that management could come out well on the return on investment.

It may be that overall fiscal policy, Murray, which has been aimed so long primarily at stimulating demand, might somehow have to be turned around principally to stimulate supply. That may be market interference but, if you are going to have interference anyway, I am on the side of interference where we get something to use rather than to stimulate consumption – which is not going to be fulfilled because of lack of supply.

A fundamental political-economic assumption for years has been that there will always be enough stupid, or wise, people around to invest in plant and equipment and to develop needed resources so that no one will ever run short of anything but money. It has been said that if people have money they will always be able to buy what they want. But who asks, "If you give them the money and they cannot find what they want, *then* what do we do?" I am convinced that we are so close to that condition that we ought to worry more about how do we get adequate supplies for the years ahead.

Actual or potential chronic shortages must be looked at by individual industries and individual companies. Any new investment must be in the interest of those who put up the money and take the risks, as well as the consumers. Right now, project-financing discussions around the world are more active than ever before. There are more and more people looking for ways and means to stimulate new investment in many developing countries. The Arabs, for example, want suitable projects in which to invest. So, it is not a hopeless process at all to get a major worldwide wave of investment under way soon. It is vital that we do.

MR. GRANT: I would like to ask Walter two specific questions, because he was so good about the Interest Equalization Tax (IET) last year, forecasting that it would come off this spring. What are the chances of the withholding tax coming off, which in my judgment could bring a large amount of foreign funds into this market? And secondly, by the time we meet next November, will the United States Government officially have approved personal purchases of gold?

MR. HOADLEY: On withholding, Bill, unfortunately the outlook is not too encouraging. In fact, there is a rather negative political attitude at the moment with respect to easing taxes on international capital flows. However, there is not a generally unwelcome attitude toward more foreign capital investment in the United States. In fact, foreigners may fare better than we do. But tax concessions carry the overtones of somebody getting a free ride, and that is not popular these days.

Probably, we have to experience more of these shortages to get political support for action. We have to see the absolute political necessity of inviting, or persuading, more foreign capital to come into the United States in our interest. I do not think we have quite reached the stage of ending withholding; I am only hopeful.

On the public ownership of gold, I would hope eventually that the U.S. public could buy and use it. What concerns me is that there are too many people around the world ready to take advantage of us. At some crucial point, it is widely assumed abroad that our political leadership in the United States is going to show how strong we are by saying it is all right for the public to have gold. If so, it is going to flow into our country from all over. Much of the American public is going to be had. I think such a move would be quite inflationary, and then deflationary.

I would say the odds are now less than 50-50 that we will see a free U.S. gold market this year. But I do not rule out the possibility that some Sunday night – in the midst of new strains and stresses, politically, financially, and otherwise – gold will be set free for Americans to demonstrate the integrity of the dollar or of the American economy, or to restore the full faith of the American people in our system. The announcement to our voters might well be – you have been denied gold for a long time, now let us correct the evil of gold being available only for foreigners.

CHAIRMAN SOMMERS: That would be Sunday night. The peak in the price of gold would be about the following Thursday, wouldn't you say?

Several of us around the table have blamed the insatiable demands of the consumer for at least part of our problems. For a defense of the consumer and television sets, we turn now to Bob Eggert.

Inflation and Personal Consumption

Robert J. Eggert

MR. EGGERT: The causes of the severe inflation experienced by the United States during the past year are both controversial and overlapping, as we can see from our discussion here today. However, in my judgment, the severe inflation we have had in recent quarters can be ascribed to many of the factors that have already been touched upon. To recap, these include: (1) a set of unfortunate concurrent events, ranging from the temporary disappearance of anchovies off the coast of South America to wheat-crop failure in Russia, drought in Africa, India and other parts of the world, and the drastic effect of the Arab oil embargo; (2) an excessive U.S. and worldwide monetary expansion and a resultant uniform consumer spending boom in many of the industrialized nations of the world during the last half of 1972 and early 1973; (3) an average annual $20 billion federal deficit in the United States during the 1971 to 1973 period which was not fully offset by budget surpluses at the state and local government levels; (4) price controls that were doing more harm than good by discouraging needed expansion in productive capacity and by encouraging (with the aid of several sharp devaluations of the dollar) the export of large quantities of scarce raw materials to more profitable foreign markets; and (5) a sharp drop in private nonfarm productivity to negative levels during the fourth quarter of 1973 and the first quarter of 1974 meant that expanding labor and other costs have had to be fully reflected directly in prices.

There are some potential cures coming into the picture – perhaps for the long range. I think the two-digit inflation we have been experiencing is extreme and I do not think it will continue for a very long time. I see four different things that are shaping up which can help "cure" our two-digit inflation.

First, a sharp expansion in food and feed-grain products in the United States as a result of the belated release of 50 million acres in government soil-bank programs and, hopefully, more normal weather conditions. It will take another year or two to fully translate these larger feed-grain supplies into expanded production of pork, beef and eggs – protein food items that continue in relatively strong demand.

Second, plant and equipment expansion which is being planned at a rapid rate (19 percent over a year ago). Even if we allow for inflation and some postponed plans, this should help reduce serious capacity shortages and increase productivity. Caution is needed by the Federal Reserve Board in not overdoing the curtailment in the growth of money supply and the resultant excessively high short-term interest rates, which might dampen the much needed expansion in capital investments.

Third, a declining rate of government expenditures and a somewhat better balance of federal, state and local budgets during fiscal 1973 and 1974 should help to take the edge off demand pressures for scarce goods and services.

Fourth, steps will be needed to encourage an improvement in productivity to moderate the effect of accelerating wage demands springing from the severe inflation and the resultant 3 to 4 percent drop in real wages during the past six months. For example, there should be serious consideration of employing the tax system to provide incentives for investment in industrial research – a strong contributor to productivity. And I would include marketing research and economic research, as well as technical research.

MR. REES: As an economist, I would not feel justified in advocating tax credit for economic research.

MR. EGGERT: Maybe we would have to limit the amounts for marketing research. A great many products are brought into the market without enough research and without enough attention to what the market needs – the Edsel is an outstanding illustration.

MR. REES: Marketing research is already a deductible business expense.

MR. EGGERT: We could get into long debate about that. As for technical research, the problem is whether an individual company can do it and take the risk.

MR. GRANT: In the basic industries, for the first time since the middle and early Fifties, we have product prices which make it attractive to do research in terms of more efficient output with a higher profit margin. We have an incentive factor here which we have not had for a long, long time.

MR. WEIDENBAUM: I think what worries people is that, in real terms, the declines in defense and space research and development spending have not been offset by a comparable increase in civilian R & D.

MR. EGGERT: But the United States may be lagging behind and other countries are getting ahead. You may say that we *should* have the incentive, but we just don't. Other companies and countries who just copy can latch on to the profits too fast; that is another thing that is happening.

MR. GRANT: I guess I'm a little more optimistic. The country has lost its reputation unfairly because we did not make transistor radios cheaply; we did not make the cheapest television sets, sporting goods, and small automobiles. But in traveling around the world, one can't help but notice U.S. labels on farm equipment, heavy machinery, offshore drilling platforms and gear, nuclear plants, mining equipment, tractors, and so on. I am not referring to our obviously strong competitive positions in such industries as computer technology and pharmaceuticals. In building the hard-core infrastructure of the world, we are a lot more competitive than we think we are.

MR. EGGERT: I just want to be sure we stay there. I think research of all types helps productivity. But, to move on.

There has been a big jump in consumer credit, as we all know, between 1972 and 1973 – a 15 percent increase. One of the ways consumers are reacting to inflation is by reducing credit demands. The net change in installments has come down very fast, partly because the automobile sales figures have dropped so sharply. For some months last year, the change was running at a $20 billion rate, and now it is down to a $10 billion rate. There has been a big adjustment in the way consumers have reacted, partly as a result of the oil embargo and its effect on automobile sales, which are still a big part of the credit picture. However, one

Table 9: Installment-Loan Delinquency Ratio (February 28, 1974 and December 31, 1973

Type of Loan	*February 28,1974*	*December 31, 1973*	*Percentage Increases, 1973-1974*
Personal	3.24	3.07	+ 6%
Automobiles: Direct	1.66	1.66	0
Automobiles: Indirect	2.55	2.37	+ 8
Home appliances	3.33	3.26	+ 2
FHA Title I home improvements	2.78	3.04	– 9
Property improvements (bank plans)	2.20	1.83	+20
Mobile homes	4.34	3.54	+23
Recreational vehicles	2.49	2.53	– 2
Total	2.69	2.53	+ 6%

Note: Number of delinquent loans as a percentage of total number of loans outstanding.

Sources: American Bankers Association; RCA.

could argue that the pattern is more one of *over*extension last year, than correction now.

MR. GRANT: What do the numbers look like now into 1974?

MR. EGGERT: They will probably only increase by 8 percent this year, compared to 1973's 15 percent rise, based on the early evidence.

One other problem that could be blamed on inflation, at least in part (although it is hard to separate the effects of inflation from the sluggishness of the economy) is the very sharp increase in delinquency rates. Delinquency rates – and this is part of the concern about bank credit – have been going up. The installment-loan delinquency ratio is at its highest point in 24 years. One area where delinquencies seem to be increasing very rapidly is property improvement loans, and also in mobile homes.

MR. HOADLEY: Our experience has been surprisingly good, on the whole. The mobilized home field, however, is one which obviously has come in for some recent trouble.

MR. EGGERT: Another reaction of consumers to inflation seems to be a *decreased* rate of saving. The Survey Research Center has stated that, in the past, inflation actually seems to encourage people to save. I think you can find that in George Katona's books and throughout his annual reports. But if you look at the evidence, it would appear to me that it is not true in recent years. Consumers are beginning to act more and more like businessmen. If consumers anticipate inflation, they buy today rather than wait. And I think the evidence shows that when inflation is strong, the saving rate goes down; when inflation diminishes, saving goes up.

CHAIRMAN SOMMERS: Is it possible it runs the other way? That the low

Table 10: Changes in Consumer Prices, by Country

(Percent Change in Twelve Months)*

	1973												1974		
	Jan.	Feb.	Mar.	Apr.	May	June	July	Aug.	Sept.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Argentina	63.2%	69.4%	76.5%	75.0%	80.2%	66.3%	58.5%	61.5%	58.8%	52.4%	44.7%	43.8%	...	...	...
Australia	5.7	5.7	5.7	8.2	8.2	8.2	8.2	10.6	10.6	10.6	13.2	...	...	...	...
Austria	8.0	8.0	7.6	7.9	8.1	7.2	7.1	6.9	6.5	7.0	8.0	7.8	8.0%	8.4%	9.0%
Belgium	6.9	6.8	7.0	7.2	7.4	7.0	6.6	7.0	6.7	6.8	6.7	7.3	7.5	8.4	9.5
Brazil	14.0	13.0	13.0	13.0	14.0	13.0	12.0	12.0	11.0	12.0	13.0	14.0	14.0	...	...
Canada	5.7	5.9	6.1	6.6	7.3	8.0	7.7	8.2	8.5	8.6	9.3	9.1	9.1	9.6	10.4
Denmark	7.2	7.8	7.6	8.4	8.7	8.7	9.3	9.6	9.9	10.3	11.3	12.6	14.3	13.5	...
France	6.7	6.4	6.4	6.7	7.1	7.3	7.4	7.6	7.8	8.0	8.4	8.4	10.3	...	...
Germany	6.6	6.4	6.6	7.0	7.3	7.6	7.3	7.2	6.2	6.5	7.4	7.8	7.4	7.6	7.2
Italy	8.1	8.7	9.3	10.4	11.0	11.0	11.2	11.8	11.3	11.1	11.4	12.6	...	...	...
Japan	6.9	7.3	9.0	10.0	11.3	11.6	12.4	12.6	14.2	13.2	14.9	17.2	20.4	23.5	21.6
Mexico	6.5	6.6	7.3	7.6	8.9	9.8	11.8	11.8	13.9	14.8	15.1	20.2	21.4	...	...
Netherlands	7.8	7.5	7.7	8.0	8.3	8.3	8.3	8.1	8.2	7.9	8.0	8.2	7.9	8.4	...
Norway	.9	7.5	7.7	7.9	7.8	7.8	7.4	6.7	6.8	7.4	7.7	7.6	8.5	8.9	9.0
Sweden	6.0	6.0	6.0	6.0	6.0	7.0	7.0	6.0	7.0	7.0	8.0	8.0	8.0	11.0	...
Switzerland	7.4	7.5	8.2	8.4	8.0	8.2	8.3	8.2	8.3	9.5	10.8	11.9	11.6	10.1	9.6
United Kingdom	7.7	7.9	8.2	9.2	9.5	9.3	9.5	8.9	9.3	10.0	10.3	10.6	12.0	13.2	...
United States	3.6	3.9	4.7	5.1	5.4	5.9	5.7	7.5	7.4	7.9	8.4	8.8	9.3	10.0	10.2

*Changes over corresponding month of preceding year.

Sources: International Monetary Fund; U.S. Department of Labor; RCA.

Table 11: Consumer Price Indexes for Commodity and Service Groups, and Expenditure Classes (March, 1974)

	Consumer Price Index for March	*Percent Change from One Year Ago*
Fuel oil and coal	201.5	57.7%
Gasoline and motor oil	157.4	39.3
Cereals and bakery products	158.6	33.3
Dairy products	151.5	24.7
Other foods at home	150.2	21.9
Food at home	160.6	19.7
Fruits and vegetables	162.5	18.8
Food	159.1	18.3
Fuel and utilities	144.9	16.3
Nondurable commodities	147.2	14.7
Nondurables less food and apparel	138.5	14.7
Food away from home	153.7	13.3
Meats, poultry, and fish	171.6	12.4
Gas and electricity	140.0	12.0
Commodities	141.0	11.8
Nondurables less food	136.1	11.2
Household services less rent	158.8	10.9
All items less shelter	141.5	10.7
Housekeeping and home maintenance service	165.3	10.6
All items less medical care	143.1	10.5
All items	143.1	10.2
All items less mortgage interest costs	141.7	9.8
Home ownership	157.2	9.8
Housing	144.9	9.5
Private transportation	130.4	9.5
Insurance and finance	158.8	9.0
Transportation	132.0	8.6
Shelter	149.4	8.5
Services less rent	150.4	8.0
Commodities less food	131.1	7.9
Household furnishings and operation	132.6	7.8
All items less food	138.4	7.8
Services less medical care services	146.2	7.7
Services	147.0	7.6
Medical care services	152.7	7.4
Utilities and public transportation	138.2	7.2
Personal care	131.8	7.1
Medical care	144.8	6.6
Other services	137.6	6.5
Other nondurables	126.7	6.2
Apparel and upkeep	132.2	5.9
Household durables	123.7	5.8
Men's and boys' apparel commodities	131.8	5.8
Other durables	134.7	5.7
Apparel commodities less footwear	131.6	5.7

Table 11: (continued)

	Consumer Price Index for March	Percent Change from One Year Ago
Apparel commodities	132.1	5.5
Health and recreation	135.4	5.3
Women's and girls' apparel commodities	131.6	5.2
Footwear	134.9	4.8
Alcoholic beverages	127.1	4.8
Rent	128.4	4.7
Other goods and services	132.8	4.1
Reading and recreation	129.5	4.0
Durable commodities	124.3	3.4
Tobacco products	139.4	2.9
Transportation services	139.6	2.4
New cars	112.8	1.8
Public transportation	146.6	1.5
Appliances (including radio and T.V.)	106.5	1.0
Used cars	102.2	−10.1

Note: Price indexes ranked by order of magnitude of percent changes.

Source: Bureau of Labor Statistics.

saving rate produces high inflation, and the high saving rate contributes to deflation?

MR. EGGERT: Well, there probably is a correlation there.

MR. HOADLEY: We still find a rather stable relationship between inflation and savings, falling within a traditional correlation band. However, it is moving to some degree in the wrong direction.

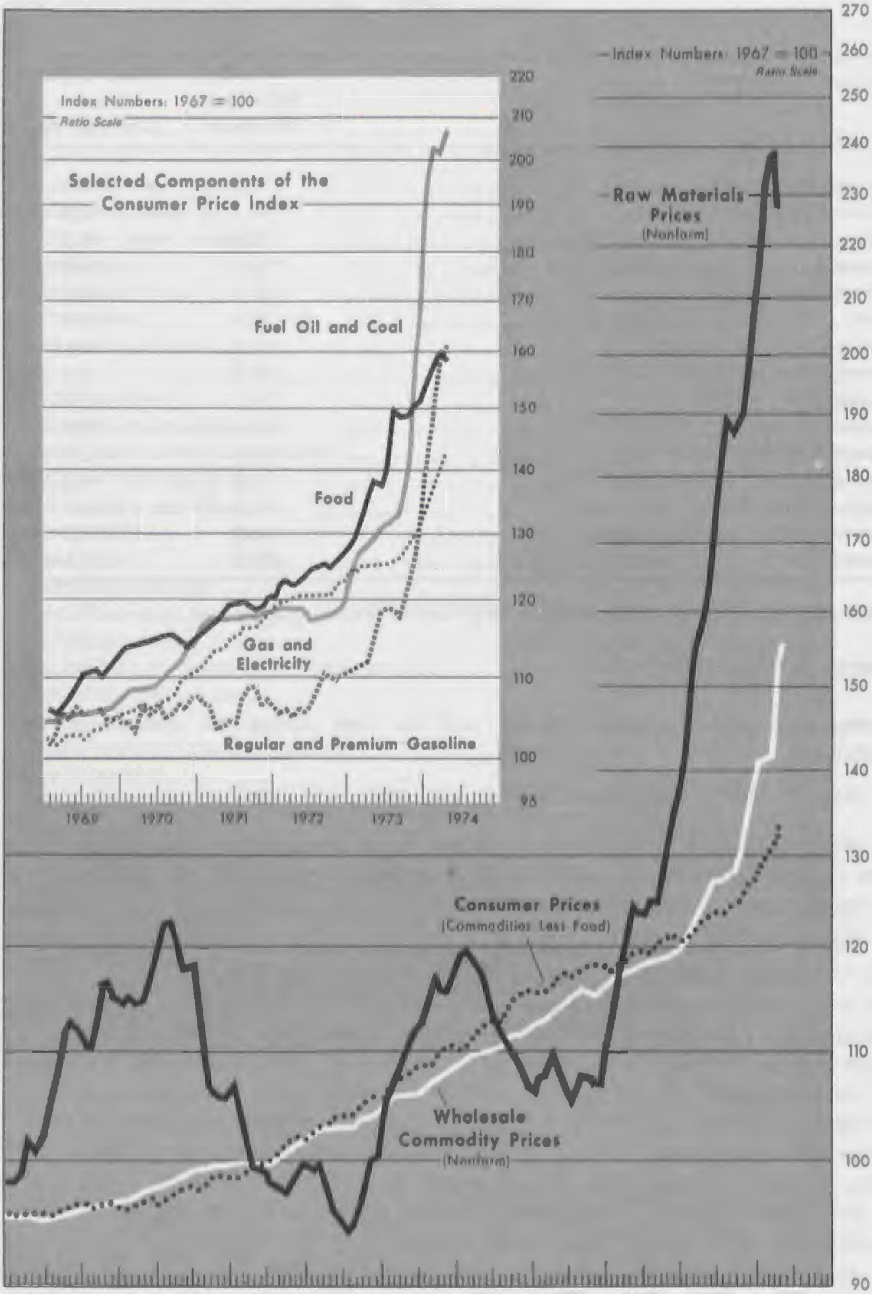
MR. EGGERT: Now, I expect the most violent reaction from this group to my last point. I was happy to hear Jim O'Leary say that it takes more money to do business in a period of inflation. If you use the narrow definition of money supply (and I think you get about the same answer if you use M_2, or even M_3), right now money may be too tight.

Of course, you do not want to *validate* inflation, but I believe that you must recognize the very severe effects inflation can have on money and spending and allow for it somewhat, which is why I believe there should be a band around the rate, to allow for some discretionary policy decisions. This means, in effect, that if you want to correct the excesses of past policy errors, you should be very gradual and avoid severe economic disruptions.

In the past, monetary policy has been too liberal. But right now, it is below the two percent band, and I believe that is too tight. I am not arguing that it should be *above* the normal trend, but I am saying that there is a need for concern, particularly if this begins to interfere with plant and equipment in-

Three Levels of Goods Prices

Chart 18



Sources: U.S. Department of Labor; The Conference Board Chart Service

vestment. I know that at RCA, with our need for inventory, it takes more money at a high inflation rate just to finance *normal* inventories.

Walter, Table 10 certainly bears out the comment you made earlier about the current inflation being a worldwide problem. There is no question about it. Table 11 supports one of the points made about the causes of the current inflation. Some of these factors, at least for the consumer price index, have surely been of an unusual nature: the food shortages, the fuel shortage, and the oil embargo. But there are some items that are below the average; in fact, some of them quite a bit below the average, although used cars are the only negative.

One other encouraging development is that commodity prices have already dropped. I would say we've had a substantial correction, an 11 percent drop in actual commodity prices and a 17 percent drop in futures. If you take the BLS 22 basic commodities price index, it is off by approximately 6 percent. However, if you take individual items, some have dropped substantially. Hogs are off by 59 percent; eggs are off 60 percent from the peak; and soybeans are off 57 percent from the peak. We have had some very, very sharp drops already in some of these agricultural commodities.

MR. GRANT: It has not come through in the consumer price index yet, because the distribution function of the economy was badly hurt.

MR. EGGERT: Inflation, one would think, has caused consumers to back away from some of the items that are relatively high-cost protein, like beef and pork. The data show that in the first quarter of this year, however, people were spending as high a percentage of their income on both beef and pork as they had spent earlier.

MR. REES: What happened to the physical quantity? That is perfectly consistent with their buying less beef and pork.

MR. EGGERT: Physical quantities in these two areas are determined by what is produced, not by what people want to consume *in the short run*. You cannot look at consumption as being what people want in the meat area. The price is the equater for the supply that comes on the market. You have to look at price times quantity against income. And these data show remarkable stability – inflation has had little effect on how much people are willing to spend.

Turning to durables, color television, for example, industry figures show that color television sales are holding up remarkably well, quite in contrast to automobiles. It would appear that inflation, if I may address myself to the specific question, may actually be helping some durable goods sales to maintain their volume. Here is a case where volume, rather than price, is holding up quite well. Also, there is a little bit of evidence that retail sales have shown improvement over the previous year. That suggests that people are still willing to spend money. Now, it may be the fact that consumers expect durables to be higher in price later on – so they buy now. I think there is an element of that sort of psychology among consumers.

CHAIRMAN SOMMERS: Dan, the last point that Bob mentioned is a logical connection. We turn to you for the attitude of the consumer toward inflation and other concerns.

National Attitudes and Inflation

Daniel Yankelovich

MR. YANKELOVICH: I think Walter's comments and Bob's figures provide a very good introduction for the comments I am going to make, and they are completely consistent. I didn't know these figures that Bob had and find them very interesting. I was surprised that my own figures show that for different reasons people are not postponing purchases of big consumer durables. A certain stability in psychological attitudes and values toward saving, spending and investment, and a conviction that we do not have to live with inflation and that we can bring it down, are characteristic of the point of view of the American public.

I want to make a few comments on how people are responding economically and politically at the moment, and then make a few speculative remarks about the future.

There is a difference, in looking at the future, between a very pessimistic outlook and very moderate projections. Perhaps we discerned this around the table earlier. The public expresses enormous concern about inflation, and it is far and away the number-one problem in the country – mentioned spontaneously by 65 percent of the people as being their major concern. (Its next concern is Watergate, mentioned by 38 percent, and topping the list of all other issues.) The major concerns, when you get beyond this generalized, global concern with inflation, which is fed by daily encounters with sharply increased prices, focus on food and saving. Saving attitudes are very much in line with what Walter said. There is an intense desire to preserve traditional saving habits. By more than two-to-one, people today still feel that they want to make sacrifices, if necessary, to preserve saving habits, rather than to play it smart. The "smart operator" concept of how to beat inflation is not the prevalent attitude of people in the United States. There is a group which does not feel that way, and it may account for some of the slight differences that you see in the saving figures. But the differences are fairly moderate. What is perhaps more important, and should be kept in mind, is the mainstream holding on to the traditional value point of view.

This has surprised me. With the kind of gloom that you see in the papers, and with the kind of gloom that we were talking about this morning, I thought that people would be much more panicky than they seem to be. They are not really responding to this very high rate of inflation with radical changes of any kind. It is more a matter of adjustment: sail trimming, belt tightening, and trying to dispense with the luxury of careless and impulse buying; maybe a little bit more picking and choosing in food and clothing, and a willingness to postpone the purchase of some items. As I said, there is a serious effort to maintain savings.

There is enormous confusion on this issue, and division about whether to buy now or later. There is an inconsistency in the data in that people will agree with both ideas. It is not always the same people – but there is some overlap. And the reason is, I think, that in times of confusion people tend to fall back on their traditional ways. We may be seeing a period of transition. If we continue a double-digit kind of inflation, we may not see this moderate picture continue. But I am giving you the cross-sectional picture, as of the moment. And, as of the moment, there is a ready acceptance by people of inconveniences with respect to the gas shortage: things like the alternate days, lowered speed limits, and cutting down use of electricity. People are responsive to these moderate inconveniences.

MR. EGGERT: They almost seem to be more so than they were a year ago when we had the meat strikes and all that upheaval.

MR. YANKELOVICH: What you get is this peculiar picture of agitation in the abstract, not really moderate economic behavior. The exacerbated mood comes out in political reactions, not in private economic behavior. And the political mood is that the country is off balance; that the problems are unusually severe; that we are losing our world economic leadership; and that confidence has been shaken. There is a very clear-cut, an unusually clear-cut, perception of the cause of these problems. It is a combination of the perceptions that big corporations take maximum advantage of the consumer, and that government is inept in dealing with the issue. They feel it is partly government's ineptness, and partly its sympathy with big business, which permits big business to be exploitative at will. When you see declines of public confidence in business *and* in government, they are not equatable. The decline in confidence in government is because it is not doing its job in policing business. In any kind of a crunch, the support is always for government.

MR. WEIDENBAUM: The survey showed that big business seems to be rated much lower than small business.

MR. YANKELOVICH: That is absolutely correct. The villain is big business. It is not the retailers; it is not the middlemen. For example, people feel very differently about the gas stations making more money and the oil companies making more money.

Watergate and inflation have been merged in the public mind. President Nixon and big business share the honors, with big business a shade ahead of Mr. Nixon — a shade ahead in the sense of more blame. The one criticism that was leveled against the President in 1972 was that he was too close to big business and favored it too much. People voted for him in spite of that in very large numbers, because of his foreign policy, and so on. However, that has now come back to haunt him, and to be reinforced. I want to emphasize how specific that point is. Whatever has happened, with regard to inflation and Watergate combined, has not shaken the basic value support for the free enterprise system. There are no true desires for business to be taken over in the same way as a European company might be taken over. There is, nevertheless, enormous anger against the idea that big corporations are profiting at the expense of the public.

One of the ways the anger operates is fundamental, and I do not think that many executive committees, whose meetings I have attended, recognize the distinction between a situation in the country where everybody is gaining and where the feeling of the people is, "I don't care if somebody makes 40 times as much as I do, or if these corporations make out well, as long as I am doing well also." No anger; no animosity; but complete acceptance of gross inequities. But this is completely reversed if the perception is that the reason companies are making out well is that they have their hands in our pockets. The political consequence is the very simple idea in the mind of the public that you cannot trust big business because it will act for its own selfish ends. And that is the mood – the political mood – of the country today.

MR. EGGERT: Are the oil profits the background for that?

MR. YANKELOVICH: They are the visible part of the iceberg. The oil profits exacerbate and dramatize, and then it is generalized somewhat beyond that.

Commenting on a few of the remarks that have been made today, I would say there does not seem to have been any intense increase in the desire for redistribution of income, that kind of thrust for equality and equity. The acceptance of the way the system generally works is too deeply engrained.

However, among the changing factors you do see, one is structural. We have papered over many potential social problems in this country because of our excellent industrial growth – as compared to Europe – industrial growth based on cheap energy; no questions about supply; the ability of the United States to use disproportionate amounts of the world's raw materials and resources. The stresses and strains we are witnessing are not really massive increases in the sense of entitlement on the part of the public, but the same desires we have stimulated in the public for higher aspirations, for higher demands for products and goods, for higher levels of material well-being and intangibles. The economy needs a high growth rate to meet these needs.

There are some changes, some psychological forces working in the country, among the people who have had a taste of affluence. There has been a certain disappointment with the results of affluence.

MR. GRANT: Do you mean the young of the higher-income classes?

MR. YANKELOVICH: No. I am saying those who have tasted it, not only the young and the middle-aged. It has been demystified, to use the popular term, among those who know it – just like the presidency. But you have to know affluence for it to be demystified. Most of the public, which has not had that taste of affluence, is committed to it, in a traditional sense, and is also committed to the welfare state, to government itself, and to all of the social changes we have seen. And I cannot foresee anything but an ever-increasing rise in that component of federal expenditures. This is where the social rights are tied in – medical care and education, for example – for new groups of people. It is not that we have an entirely new situation of everybody escalating their sense of entitlement, but new groups, with new demands, are coming into the act now, exercising their rights.

If you take this mishmash of factors – structural and psychological – and the kinds of constraints that may play on both the country's and the world's economies, and the new concern with sources of supply and all the rest, it adds up to changing patterns of demand. I do not understand exactly the form in which the change is going to take place. But if we are going to have the kind of social stability we have had, and if we are not going to be able to achieve it through high levels of industrial growth, then something must give. And one of the things that is going to give is going to be demand, in my opinion.

We have just released a new youth study. One of the central points is the shift of values that had incubated on the college campus to noncollege youth.

For the college students the stress points were the university – their emphasis has been in the political arena. The stress points for the noncollege youth are not going to be the same; they are going to be the workplace and the family.

In the workplace, where young workers tend to take their ability to make a living increasingly for granted, the stress is now on interesting work, on work that will give them a chance to use their minds – the quality-of-life intangibles. They are new incentives, in a sense. They represent a new frontier. They unlease energies, if you can satisfy them. On the other hand, if you frustrate them, they turn people off.

I think the turning off has an impact on productivity. Jack knows more about this than I do. Many parts of the country are ready for various intangible forms of self-fulfillment. The economic realities may force us to put more stress on them in the future and to start modifying the enormous emphasis that we put on stimulating demand for goods or products. As was pointed out, we have to do something about demand levels for high-income groups. We have created the consumption monster partly because of economic logic. What I am saying is that there will be shifts, both in economic and psychological values, that will change our emphasis substantially in the future.

MR. GRANT: It's even broader than that. Again, I'll point to the excessive consumption of electricity (a luxury to some extent), the small-car trend, less foreign travel, and the disappointing sales for such luxury lines as expensive cameras, toiletries, specialty white goods, and so forth.

MR. YANKELOVICH: There is a not-too-submerged tradition of puritanism in the American people which is very strong. And somehow, a shift in emphasis might be greeted with an enormous sigh of relief. People would not like it; they would kick and complain a little bit; but there would also be receptivity and acceptance.

You have to qualify that by which social and income groups you are talking about. The basic splits in the country are between the people who have had some taste of affluence – and I don't mean high income, but just a moderate period of living fairly comfortably – and the people who have not had that. That is where the real line of polarization is going to come, as to how people are going to respond. There is a chance that the first group is going to be able to make these adjustments more readily.

MR. GRAYSON: I see a glimmer of sunshine coming through there. If that is true, there *are* a lot of moorings still there which are holding anchors to all these winds and tides. That is a good report. How much time do we have for the economic system to respond, so that we get some encouraging downturn, and so that we can have all those good things that Walter talked about internationally? The economist's lag is the politician's nightmare.

CHAIRMAN SOMMERS: We will have a nightmare unless we do something, if I understand Dan's description. A simple decline in materialism is not an answer to a system that is built so heavily around stimulation of consumption. We would have to find alternative ways of balancing resources in the system, would we not?

MR. YANKELOVICH: Absolutely. Very complex and novel ways will emerge.

MR. HOADLEY: But Dan, don't we have to go through another period of acute shortages to convince the public that this is not a phony problem? Perhaps only then will it show some feeling of renewed support for the importance of business in providing goods and services for all.

MR. YANKELOVICH: It depends on the context in which those shortages occur. If they occur in the atmosphere of responsible political leadership, yes. But if the shortages occur in the kind of political nonleadership that we have today, they will simply stimulate more hostility, more animosity. It is a critically important point.

To sum up, in terms of time, it is a race between the economist and his tools, and the political furor. My plea would be not to depend on the market, in this kind of chaotic climate, to bring people into line. There is political impatience with big business and with the political system that is going to force some unwelcome and unproductive economic measures via the Congress unless economists come up with some suggestions that will take the political realities into account. The price pressure – what is perceived as price exploitation for the sake of maximizing profits – is bothering the hell out of the American public right now. And it will have far-flung political consequences.

CHAIRMAN SOMMERS: That repeats the point you made very tellingly in November: the removal of price controls would precipitate the kind of attitude that you have described. We are going to have to drop this subject for a time, and turn to Bill for the happy outlook for the financial community, or what's left of it.

Inflation and Financial Markets

William R. Grant

MR. GRANT: Thank you, Al, for that cheerful introduction. My remarks will stress the meaning of inflation but we do first have to define where the markets are. Since 1968, the so-called averages do not indicate what has happened to most investors.

Chart 19 shows that the unweighted average of all markets is off 70 percent from the peak in 1968. The New York Stock Exchange is off 60 percent, and the AMEX, 80 percent. The over-the-counter market is at least as bad as the American Stock Exchange. When you add all this up, we are really talking about a decline in paper value for all stocks whose highs were made at the high of the averages in the fall of 1968, or subsequently. This approaches several hundred billion dollars of paper-value decline.

If we all sat here a few years ago and forecast that would happen, I do not think we would have assumed what subsequently happened in the economy in terms of inflation, the bond markets, and the physical output of the economy. But it is a staggering number, even in an economy as large as ours.

The market is cheap, as measured by the absolutes of price-earnings ratios, and in many cases, by current dividend yields. This is true even if 1973 earnings are reduced by 25 percent to make up for inadequate depreciation and price inflation. All markets, in my opinion, are essentially a reflection of society. If we have a very distorted society, we will have a very distorted stock market, and that is where we are today. Let me give you some idea of the extent of the distortion. IBM's 147 million shares, despite the fact that they are off $18 billion in value from their high, are still selling at a total market value greater than all 3.4 billion shares on the American Stock Exchange. And I suggest, in all deference to IBM, that is a pretty good swap, taking the slightly longer viewpoint.

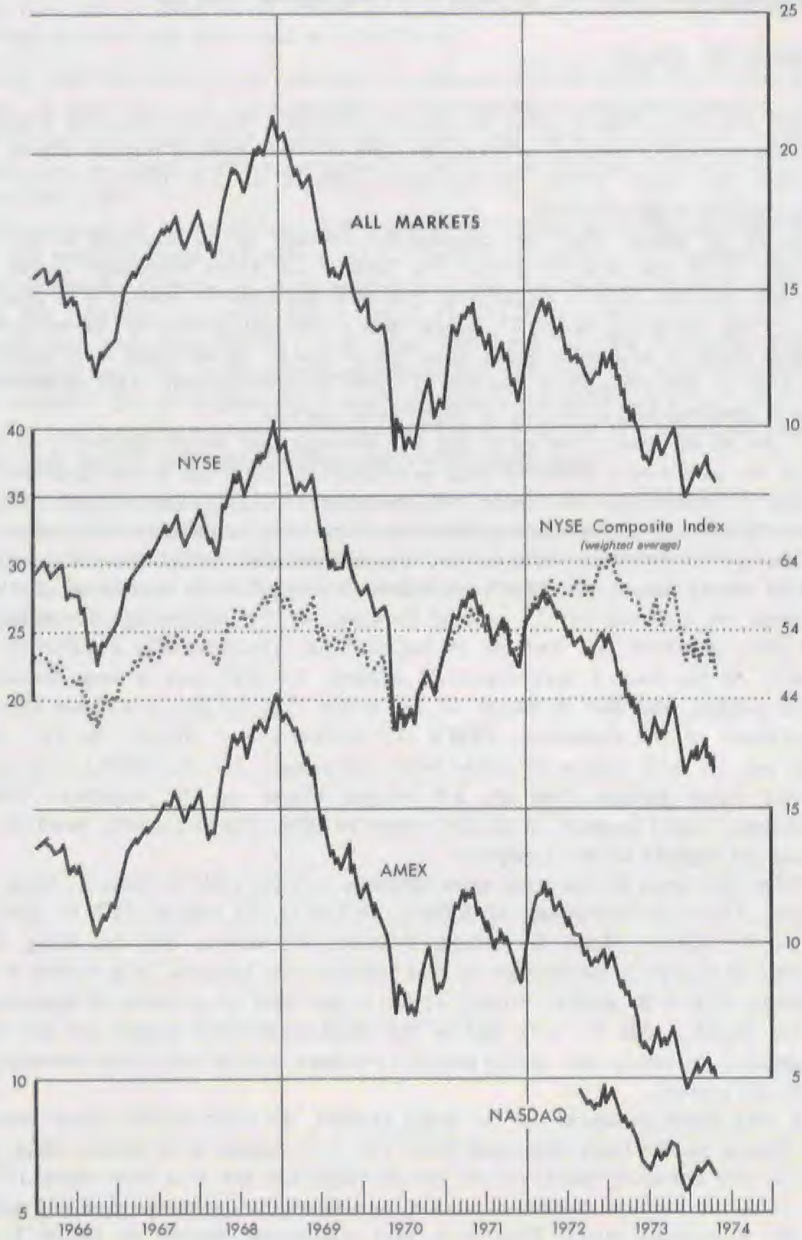
Now, for some of the total value declines: EXXON off $7 billion; Avon $6 billion; American Telephone $6 billion; TEXACO, $5 billion; ITT $5 billion; Xerox $3 billion; Mobil $3 billion; Polaroid $3 billion. But the thing that catches one's eye is the decline of past institutional favorites (e.g., Levitz is off a billion dollars in market value). This will give you some order of magnitude of the declines that we have had in this market, which I suggest are not well recognized; certainly not in the popular averages, which only show declines of 20 to 25 percent.

A very brief comment on the bond market. We experienced a huge loss in purchasing power from declining bond prices. I suggest it is greater than the loss in the common stock values. Incidentally, for the first time since 1970, the public is back in the bond market, as witness its purchase of recent issues in the 9 percent range. That is a very significant factor, as far as I am concerned, in looking at possible positive market trends. Current short- and long-term rates are too competitive for stock prices.

If you refer to Table 12, "Purchases of Corporate Bonds by Various

Trade Level of Unweighted Market Averages

Chart 19



Sources: New York Stock Exchange; American Stock Exchange; National Association of Securities Dealers Automated Quotations; The Conference Board Chart Service

Investor Sectors" (see page 86), you will see that the public purchased $10 billion of the new issues of 1970, or roughly 43 percent. This figure declined to less than one billion dollars in 1973; our guess is that we are now in a situation where the public is back into that long-term market in a relatively major way.

The public has been smarter than the professional investor because it has been liquidating stock since 1968. And the public very intelligently bought bonds at the peak of the long-term bond rates, and did not buy any, relatively speaking, in late 1972 and most of 1973. And now it is back in the market, so that is an interesting indicator of something to do with long-term rates, and, of course, for the stock market itself.

The European companies and government agencies, who have come to raise money, have not been able to raise it in the U.S. market. The institutions have no interest. They believe they have enough problems in lending out money at home. Most of those government agency loans, guarantees and what-have-you have been withdrawn. Our guess is that $3 to $4 billion could not be marketed at this time.

Coming back to a direct question: "What about corporate management attitudes towards inflation?" I think, in general, corporate management – particularly in the basic sectors of the economy – after a very dry and disappointing period between the middle Fifties and we'll say 1971, is almost shocked by the earnings gains that have come through. For the first time in many of these industries (e.g., chemicals, minerals and oils) product-price increases are substantially ahead of wage increases.

From what I see, corporate earnings in the first and second quarter will range from 50 to 150 percent above the optimistic forecast of the budget for basic industries to a decline in autos and in a few industries in a price squeeze. And volume is up relatively little. It is not atypical to see a 5 percent unit increase over a year ago, and earnings up 50 to 100 percent.

I believe that borrowing to finance the sharp rise in the value of inventories is a very significant factor in the short-term interest rate. It is typical again to see inventories up 100 percent without a unit rise. I think we are at the peak of this phenomenon.

I sometimes wonder if anybody knows where the inventories are. They are not where they used to be. And I think they are very difficult to measure. Inventories are clearly not in the hands of basic producers but in processed and semiprocessed form, close to the end consumer. Wholesale inventories are large. Many wholesalers have gone bankrupt because they could not afford to carry higher inventories at current money rates. When it all unfolds, there will be a lot more inventories found, not in the basic sector but further up the line, close to the consumer. This has interesting investment implications because, every time inventories and prices came down in the last three cycles, it was the basic producer who was hit. I suspect it is going to be much closer to the consumer this time, in terms of disappointing earnings.

I think managements have no feeling right now of just how to forecast. Who does? I think they feel they are in a never-never land as to the kind of price assumptions they make. I think the sagest counsel is to focus on the changes in society and what they could mean compared to past trends. Even

Table 12: Purchases of Corporate Bonds by Various Investor Sectors
(Millions of Dollars)

	Total Net New Issues	Insurance and Pension Sector	Percent of Total	Commercial and Mutual Savings Banks, Other Finance and Foreign	Percent of Total	Households	Percent of Total
1946	$ 1.022	$ 2.102	205.7%	$– .151	–14.8%	$– .929	–99.9%
1947	2.984	3.408	114.2	.361	–12.1	– .785	–26.3
1948	4.805	4.780	99.5	.087	– 1.8	– .062	– 1.3
1949	3.276	2.993	91.4	.679	20.7	– .396	–12.1
1950	2.255	3.008	133.4	.034	1.5	– .787	–34.9
1951	3.860	3.590	93.0	.237	6.1	.033	0.9
1952	4.968	4.622	93.0	.358	7.2	– .013	– 0.3
1953	4.645	4.495	96.8	.264	5.7	– .114	– 2.5
1954	3.750	3.860	102.9	.184	4.9	– .294	– 7.8
1955	3.994	3.312	82.9	– .313	– 7.8	.995	24.9
1956	4.920	4.261	86.6	– .279	– 5.7	.938	19.1
1957	7.462	5.403	72.4	.994	13.3	1.065	14.3
1958	6.768	5.027	74.3	.429	6.3	1.312	19.4
1959	4.546	4.351	95.7	– .087	– 1.9	.282	6.2
1960	5.570	4.768	85.6	.157	2.8	.645	11.6
1961	5.607	5.521	98.5	– .055	– 1.0	.141	2.5
1962	5.859	5.943	101.4	.044	0.8	– .128	– 2.2
1963	6.570	6.380	97.1	.231	3.5	– .010	– 0.2
1964	7.104	6.507	91.6	.508	7.2	.089	1.3
1965	8.559	7.234	84.5	.345	4.0	.980	11.4
1966	11.823	8.271	70.0	1.451	12.3	2.101	17.8
1967	17.176	9.422	54.9	3.167	18.4	4.587	26.7
1968	15.000	8.300	55.3	2.000	13.3	4.700	31.3
1969	14.800	6.100	41.2	1.300	8.8	7.400	50.0
1970	23.700	10.000	42.2	3.600	15.2	10.100	42.6
1971	24.700	9.900	40.1	6.600	26.7	8.200	33.2
1972	20.100	10.300	51.2	4.900	24.4	4.900	24.4
1973	14.200	15.100	106.3	–1.700	–12.0	.800	5.6

Sources: Federal Reserve Board; Smith, Barney & Co. Incorporated now, for example, some utility people are extending their construction programs because they believe there is a secular modification of the accepted rate of historical growth. Such a simple statement has a great deal of meaning for many other industries.

It is very difficult for operating management to understand how the financial structure of the world has so much of an impact on basic economic trends. They have been struggling with below-average returns for so many years and, in the first period of above-average earnings, the stock price goes down. There is no logical explanation, and that is what concerns them. The alternatives of higher interest rates, monetary problems, and a general lack of investor confidence, do not do much to help forecast the price of a stock when a company has to raise equity.

I do sense a very early warning of management starting to face up to excess inventory stimulation. Boards of directors are becoming more concerned. Outside board members can contribute a lot in this area, because they are not so concerned with running the company and meeting a payroll and should be better able to see the forest versus the trees.

MR. REES: Do you see a tendency to use more outside directors?

MR. GRANT: Yes, I do see a major change, not only in numbers, but in involvement. And this has to be one of the positive things for the business side: the responsibility and active participation of outside board members on audit, compensation, pension fund, and executive committees. I believe it clearly means a stimulation for management.

MR. YANKELOVICH: Companies must learn to understand the changes in the socio-political environment. And they had better bring in some people outside of their own closed little groups.

MR. GRANT: I think there is still a tendency on the part of corporate managements to extrapolate the basic financial trends in the 1960's, which I believe peaked out probably two years ago. If you could define it in a very simple way, I would say that the Sixties were marked by an unexpected increase in discretionary spending power, and a decline in raw-material costs which, of course, benefited the consumer-oriented companies. Now, I am suggesting that, for the Seventies, those two fundamentals have different patterns. I do not think it is clear to a lot of corporate managements at this point in time. There is still not a great understanding that the opportunities for growth in foreign earnings, which in many cases have exceeded growth of domestic earnings, are going to be different in the 1970's.

Another corporate problem raised by inflation is current accounting. Unfortunately, the CPA's are fighting the problem that came from the conglomerate phenomenon in this country. That ball game is over. What we should be worrying about now is whether we should have two sets of books to tell shareholders what it is all about. I suggest that had some companies done this, they would not be in their present state of confusion. For example, if you are looking at a dividend payout, you must look at two sets of books. The real one deals with cash flow versus costs, rather than book cost. More managements are addressing themselves to the problem in reports to shareholders, but more formal reporting is needed. Replacement-cost accounting in an inflationary environment would place the current earnings surge in better perspective.

I do not think that anyone knows how to forecast, assuming an extended high rate of inflation at 10 or 12 percent, for a period of three or four years ahead. An overextended financial structure and a slower rate of real growth in the economy would be probable outcomes, because we cannot add debt at the old rate to hoist GNP up the hill at the same rate. What, then, does it mean if you are only going to grow 3 percent instead of 4.5 percent? The stock market always emphasized growth. That whole extreme era is over, in my opinion, and many professional investors still refuse to recognize the new alternatives.

We continue to see a dearth of real thought on what foreign instability may mean in terms of corporate spending abroad. I guess I said here a year ago that no company in one country would be permitted, by the nature of the world's social structure, to own raw materials in another country. That, now, is pretty well defined. It has pluses and minuses, depending on your viewpoint. But indeed, it would now take an unusual board of directors to commit large amounts of capital to Argentina or parts of Africa. This presents some real international problems as to raising capital for such areas. It is my judgment that the investment concern about the stability and growth of foreign earnings will spread to manufacturing in Europe. The political cracks in the Common Market will lead to more economic instability, and our neighbor to the North has already taken steps down a new road of nationalism. It is difficult for managements and investors to evaluate these new trends. But they are there; and they are real.

In terms of financing in this inflationary environment, the shortfall from internal corporate sources vis-à-vis external financing is increasing at an accelerating rate. We may be at the point of no return, where many capital spending plans are cut back because companies are not going to be able to raise the money. So we are on the low end of economic forecasts. We accept the need to rebuild basic capacity, but we do not accept the order of magnitude because we think it is at a point of limitation as far as debt-equity ratios are concerned.

In 1965, depreciation and retained earnings equaled 90 percent of nonresidential fixed investment. In 1974, our guess is that it will be below 70 percent, and still declining. And corporate liquidity has not improved – quite the contrary, according to some of the comments in the press. It has flattened out in the last two years, and our guess is that it will be down again in 1974.

We do not accept the $3 trillion investment figure which everybody uses for the next 15 years. We cannot create debt fast enough without having, in our judgment, a breakdown in the world financial structure. And we are going to have a great deal of equity dilution. It does not make for a bullish scenario for a speculative market, but rather for the total rate-of-return approach, which happens to be my prejudice. To me, investing is all about dividends, and anything else is a fad that can exist, however, for a long period of time.

A minor but important point on capital needs is something nobody talks about anymore. You know, the world (especially the young people, but also