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ECONOMIC POLICY BOARD
EXECUTIVE COMMITTEE MEETING

AGENDA
8:30 a.m.
Roosevelt Room

January 7, 1976

PRINCIPALS ONLY

1. Monthly Review of the Economic Outlook   Troika II

THE WHITE HOUSE

WASHINGTON

FOR EPB EXECUTIVE COMMITTEE MEMBERS

The attached materials are for your information.

UNIVERSITY of PENNSYLVANIA
NEWS BUREAU, Franklin Building
3451 Walnut St. 16, Philadelphia 19174

For release:
Thursday, January 1,1976

For information, call:
William M. Alrich
Tel. (215) 243- 5742

C. to EPB-Y

Economic policy makers right now in 1976--during these early stages of recovery for the U. S. economy--have to recognize that their policies might have to accommodate during the next ten years an inflation rate of 6.0 percent "built into the system," warns Dr. Ross S. Preston of Wharton Econometric Forecasting Associates at the University of Pennsylvania.

"If the policy makers assume that the inflation rate will come down soon to the 3.0-4.0 percent range, they could saddle us with economic policies that will slow down the economy several years from now," Dr. Preston said in announcing his new econometric forecast for the next ten years in the U.S. economy. Dr. Preston directs the Wharton Long Term Annual and Industry Model for the forecasting group.

Tax cuts will be a major policy problem during the next decade, Dr. Preston points out. "The federal personal tax system is progressive in nature. In the past it has acted as an automatic stabilizer. With inflation rates anticipated in the 6.0 percent range during the period 1975-1985, this progressive system could produce fiscal drag and dampen progress toward full employment."

(more)

"The Wharton Long Term forecast statement proposes that two tax cuts, totaling $50 billion in current dollars, should be planned for 1980 and for 1982-83.

At the same time, Dr. Preston's forecast points out that a target of 7.0 percent annual growth in the nation's money supply is too low to take care of "structural inflation" of about 6.0 percent a year. "If we were to target the rate of growth of money supply near 7.0 percent rather than 10.0 percent, in the long run we could expect a reduction (from the previously forecast level) of real gross national product in the neighborhood of $100 billion (in real terms)." This unrealized amount of GNP would be a significant "road block" to the return of the U.S. economy to full employment, Dr. Preston concluded.

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enc. Long Term Forecast Statement

Charts

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THE WHARTON LONG TERM ECONOMETRIC MODEL
FORECAST STATEMENT JANUARY 1, 1976
UNIVERSITY OF PENNSYLVANIA

Current performance of major economic indicators suggests that recovery is now in progress. But is the current direction of fiscal and monetary policy consistent in the long run with an unemployment rate target of 4.0 percent to 5.0 percent?

Recent projections to the year 1985 with the Wharton Long Term Annual and Industry Forecasting Model suggest two inconsistencies. Price inflation in a range above 5.0 percent has been a part of the economic landscape since 1970 with only a brief interlude in 1972-1973 when direct controls were imposed. With the recovery in progress and inflation rates declining to a range near 6.0 percent, an important policy target is a rate of price inflation that will accompany recovery as we move toward 1980 and beyond.

From our most recent long run projections (1975-1985) we have the following breakdown of inflation rates by sector of origin:

PRICE INFLATION BY SECTOR OF ORIGIN

	1975/1985 Growth Rate
GROSS NATIONAL PRODUCT	5.9%
Farm	4.1%
Mining	10.5%
Manufacturing	6.5%
Durable Goods	6.7%
Non-Durable Goods	6.2%
Transportation	6.4%
Communications	7.7%
Utilities	7.6%

(more)

Commercial	5.5%
Goverment	5.3%

Our most recent calculations suggest that the path to full employment (4.0-5.0 percent unemployment rates) will be accompanied by 6.0 percent general inflation and a breakdown by sector in which no component will experience inflation rates at or near 3.0-4.0 percent except farm. Furthermore, we anticipate two periods between 1975 and 1985 where the rate of inflation will again move close to 7.0 percent.

A 6.0 percent rate of inflation is, to an extent, "built into the system." We anticipate major price movements in fuel and utilities because of the long run nature of the energy supply problem. Continued inflation is expected in the farm sector as pressure builds to maintain the purchasing power of farm income and export demand continues at a high level. There will be continued pressure in the government sector to maintain a competitive position with respect to the private sector (the government sector price is really a wage rate). Continued pressure from world prices will influence U.S. import prices and eventually feed through to domestic delivered prices.

What does a general inflation rate of 6.0 percent mean for long run growth prospects of the U.S. economy? The Federal Reserve System has centered on a target rate of growth of money supply near 7.0 percent. Such a target will accommodate inflation in the 3.0-4.0 percent range provided that real growth is also in a range between 3.0-4.0 percent. Using, as a target, 3.0-4.0 percent inflation rates to determine the rate of growth of money supply (given potential growth in range of 3.0-4.0 percent) may be a substantial road block to full employment if, built into the system during the period 1975-1985) are extraordinary forces that will carry inflation rates in energy, raw materials and basic foods to levels far in excess of 3.0 percent.

In the Control Solution to accommodate a rate of inflation of 6.0 percent and a real growth rate of 3.5 percent (1985/1975), we found it necessary to increase money supply growth at a rate near 10.0 percent. In fact, there are weak periods (1977-1978 and 1982-1983) when money was increased in excess of 10.0 percent. Furthermore, the rate of growth of money supply was reduced during periods of strong real growth.

The target rate of growth of money supply of 7.0 percent anticipates inflation in the 3.0-4.0 percent range. But our most recent long run calculations indicate rates in the range near 6.0 percent. These results suggest that the Board of Governors should think in terms of a 6.0 percent accommodation rather than a 3.0-4.0 percent target for inflation.

(more)

P. 3. Long Term Statement

To judge the impact of slower growth in the money supply during the period 1975-1985 we have developed an alternative scenario using the Wharton Annual and Industry Forecasting Model. The net impact(in the long run) of a reduction in the rate of growth of the money supply by 0.5 percent is a reduction in real Gross National Product by $14.3 billion (from the Control Solution).

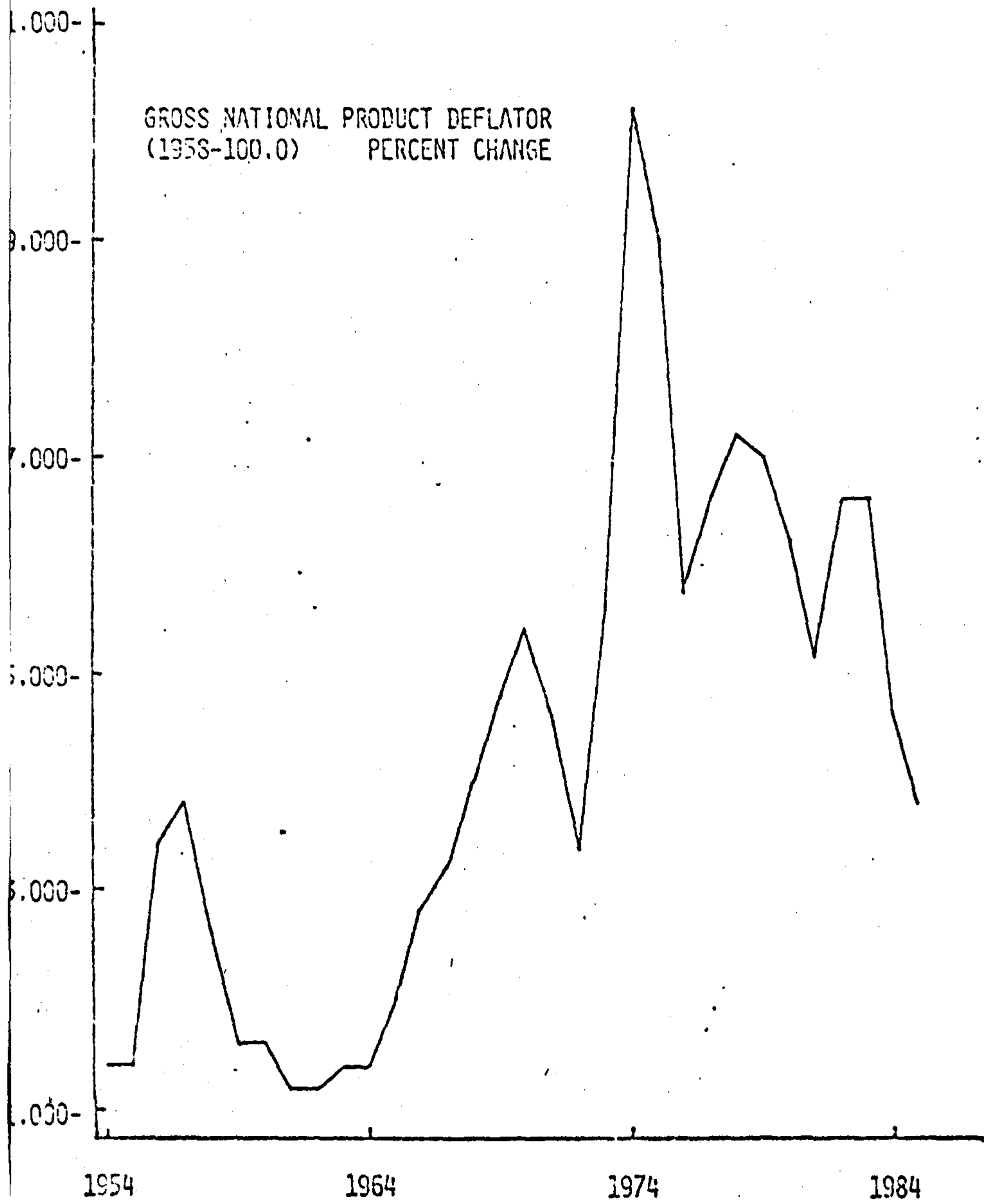
From this simple experiment we can draw the following inference: If we were to target the rate of growth of money supply near 7.0 percent rather than 10.0 percent, in the long run we could expect a reduction (from the Control) of real Gross National Product in the neighborhood of $100 billion. Given the observation that we currently are $100 billion (in real terms) below potential output as we begin the new year, money supply growth near 7.0 percent between now and 1985 could (if we are correct about our assessment of inflation) provide a road block to full employment.

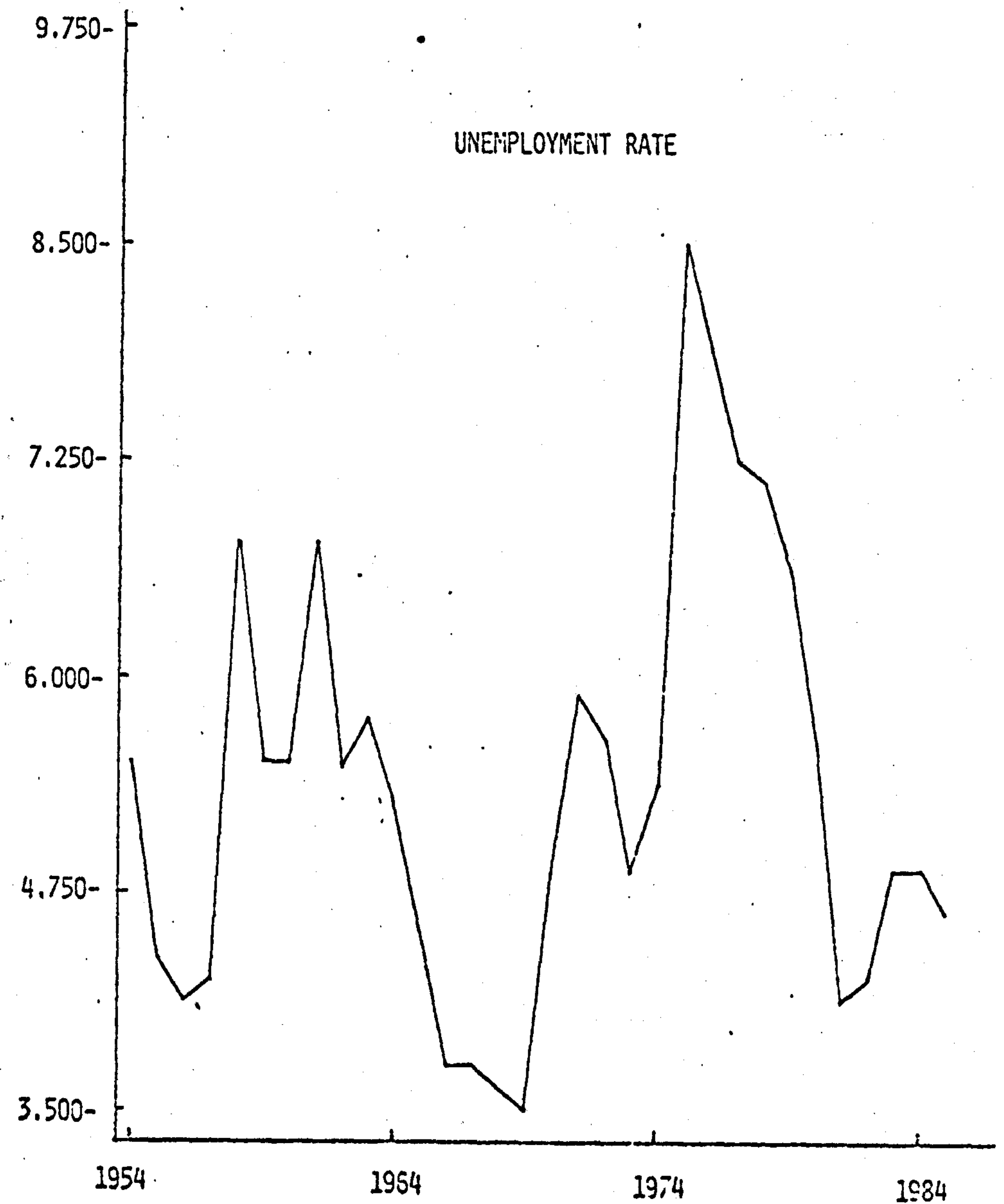
Money supply growth targets that are inconsistent with "structural inflation" may not be the only road block to full employment. The federal personal tax system is progressive in nature. In the past it has acted as an automatic stabilizer. With inflation rates anticipated in the 6.0 percent range during the period 1975-1985, this progressive system could produce fiscal drag and dampen progress toward full employment. Our control solution includes as policy inputs two tax cuts totaling $50 billion in current prices, one in 1980 and one in 1982-1983. Without these tax cuts, surpluses would develop as we move toward full employment resulting in fiscal drag.

We have focused on the issue of whether, in the long run, current fiscal and monetary policy are consistent with the target of full employment. Our most recent calculations hint at an inconsistency resulting from assumed target rates of inflation in a range near 3.0 percent. Failure to recognize these assumed targets as optimistic during the early stages of recovery may lead to a continuation of a "stop-go" economy.

Ross S. Preston
Director
Long Term Annual and Industry Model
Wharton Econometric Forecasting Associates
University of Pennsylvania

CHARTS
Wharton Long Term Econometric Forecast
University of Pennsylvania
January 1, 1976





CHARTS

Wharton Long Term Econometric Forecast
University of Pennsylvania
January 1, 1976

FEDERAL SURPLUS OR DEFICIT
(BILLIONS OF CURRENT DOLLARS)

26.000
6.000
-14.000
-34.000
-54.000
-74.000

1954 1964 1974 1984

PERCENTAGE CHANGE OF GROSS NATIONAL PRODUCT
(1958 $)

9.500
7.000
4.500
2.000
0.0
-0.500
-3.000

1954 1964 1974 1984