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12/17/74

THE PRESIDENT HAS SEEN....

THE CHAIRMAN OF THE
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON

December 3, 1974

AG — Excellent — as I read it, I find requires "good bit of concentration."

MEMORANDUM FOR THE PRESIDENT

Enclosed is a speech I delivered last night to an economists group on economic theory and policy. It is a little turgid as befits the audience but you might find parts of it of interest.

Alan Greenspan

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Remarks by Alan Greenspan

Chairman of the Council of Economic Advisers

Before The National Economists Club

December 2, 1974

"Economic Policy Problems for 1975"

The economy is slipping rather perceptibly at present. Layoffs have begun to proliferate and the unemployment rate is rising markedly.

The softening economy apparently is beginning to have a substantial impact on the rate of inflation as is now becoming evident both in the published statistics and also in evidence of mounting price discounts and other related developments. Although it is difficult at this stage to project the first quarter of 1975, it now appears probable that the rate of inflation will recede to 7 or 8 percent by the early spring. At the same time, of course, unemployment rates are moving up and are likely to reach and probably exceed 7 percent during the next six months.

I often hear it argued that because we are making progress on the inflation side and, more importantly, because the economy is slipping, the emphasis of economic policy should be shifted from fighting inflation to fighting recession.

I believe this is a false alternative. The economic circumstances of today are not those of the late 1950's and early 1960's when one could view policy in terms of such simple alternatives. Inflation and recession are not unrelated but instead reflect differing aspects of the same economic malaise. To fail to recognize and confront the problem is to perpetuate the ever worsening policy alternatives which now confront us.

Economic policy is usually directed at the achievement of several competing objectives with priorities which shift in response to economic circumstances. Conventional macro-economic policy has generally been based upon the existence of a set of options which presuppose stable and reversible underlying economic relationships. Either implicitly or explicitly the policy response functions are based upon the presumption of a stable Phillips curve tradeoff. During periods of economic slack and resource availability it is presumed that an expansionary fiscal or monetary policy leads of necessity to an increase in production and employment. Conversely, a restrictive policy is presumed to lead to reduced demand and ultimately to reduced production. Moreover, it is implicit in this context that the division of any given increase in nominal dollar demand between changes in physical volume and changes in the price level is relatively constant through time. What was not anticipated, however, was that the frequent exercise of overly ambitious stop-go policies biased towards expansion would

cause the Phillips Curve to shift, producing increasingly high rates of inflation at any given level of unemployment. As so often happens in economics, what appears both possible and desirable in the short-run may turn out to be unsustainable and undesirable in the long-run. The evidence both for the United States and for other countries around the world suggests that the Phillips Curve has, in fact, been moving to the right in recent years so that any given low level of unemployment or slack in the economy implies a rising rate of inflation through time. The shift in the unemployment-inflation tradeoff has been so pronounced as to make the very existence of such a relationship open to serious question. And this raises some very fundamental questions for macroeconomic policy.

One possible explanation for the shift in the underlying relationship in recent years involves the problem of measurement -- perhaps the statistics do not represent what they are believed to represent. Demographic shifts in the composition of the labor force have obviously caused an increase in the measured unemployment rate that is consistent with any level of excess demand in the labor markets. Not only has frictional unemployment increased as the turnover of labor rose because of composition effects but the losses to the unemployed may have fallen as well. For instance, the level of hardship

imposed by any particular unemployment rate has been falling, partly because of the rapidly rising proportion of the unemployed who qualify for and receive tax free unemployment benefits in almost all age and sex cohorts of the experienced labor force. Moreover, the average worker has a higher level of liquid assets relative to income and greater access to borrowed funds and to welfare benefits during spells of unemployment than was the case in years past. There are also a number of significant private unemployment benefit programs such as those in the automobile industry which reduce, if not eliminate, the hardship of being unemployed. Nor should we overlook the fact that the standard family today contains more jobholders than formerly and this may also have reduced the instability of family income.

These factors tend to cushion the effects of unemployment on the jobless and thereby enable the average unemployed worker to spend more time in job search. The worker is less apt to be forced to take the first job that becomes available and this tends to make the asking wage less responsive to cyclical forces. As a consequence, the measured unemployment rate would be increasingly upward biased over time as an indicator either of labor market slack or of hardship. This bias is difficult to measure statistically. In any event, it probably does not explain more than a small part of the observed shift

in the Phillips Curve over a period of years. Over short periods, of course, the marginal income loss from involuntary unemployment is still bound to rise with the rise in the level of the unemployment rate, though perhaps not as much as, say, a decade ago.

It seems to me that most of the explanation for the shift in the relationship is the result of inflation and the additional uncertainty associated with the change in expectations of the future trend of the price level. In fact, I would go further and argue that at some point inflation itself, through expectational factors and a complex set of risk premiums, becomes a depressant on economic activity which alters the shape of the policy response mechanism that is presumed by traditional contra-cyclical economic policy measures.

One major element of uncertainty that confronts the average household is the expectation of inflation. Inflation introduces uncertainty regarding the future cost of maintaining or improving one's standard of living. Consumers would be expected to react to an expectation of a higher price for a specific commodity by accelerating their purchase of the commodity to the extent that it can be stored at low cost. However, as a technical matter, consumer investment opportunities in nonperishable items other than those traditionally defined as consumer durables are quite limited. Moreover, there is greater uncertainty over specific price movements than about

average consumer price level changes. This calls for a general purchasing power reserve rather than hedge buying a few storable commodities.[1/]

In fact, most econometric work indicates that the physical volume of purchases varies inversely with price change, probably because consumers find that increased money holdings are the most desirable hedge against uncertainties. Consumer surveys also suggest that the average household reaction to expected rises in the general price level is retrenchment rather than an increase in purchases. One reason is that every household is confronted with projected budget costs for some fixed amounts of food, utilities, and housing services. Apprehension that prices on all of these relatively fixed budget items will rise in the future will cause consumers to cut back on current purchases of discretionary items in order to create reserves to help meet potential increases in their cost. In principle one would expect that households would also project a rise in incomes as a result of expected price increases, but the certainty equivalent of any such expected augmentation of household wages is probably far less than the rise in income that will actually occur on average.

Another motive for savings stems from the uncertain cost of purchases that are intended in the future -- such as the cost

1/ Hedge buying becomes a dominant force only during hyperinflation when consumers rush to convert rapidly depreciating currency into any storable commodity in the hope of preserving the purchasing power of assets. This however is not a rush to consume.

of contingencies, the expected costs of maintaining a standard of living in old age, providing for the education of children etc. Expected inflation lifts the costs of these future purchases and prompts consumers to increase current savings in order to maintain the real value of savings in terms of future purchases of goods and services. In fact, the most recent survey by the Survey Research Center of the University of Michigan indicates that only 13 percent of consumers queried suggested that inflation caused them to buy in advance. More than one-half (54 percent) indicated that they cut spending as a reaction to inflation and most of the remaining responses indicated that purchases tended to be restricted more to necessities and this is the equivalent of a cut in discretionary spending.

When expectations of rising prices are being built into the household decision-making process, we expect to see a rise in the ex ante savings function or a fall in the propensity to consume. It is important to recognize that this is related to the expectation of future inflationary increases and not to current or previous price increases, except insofar as these enter into expectations. Or more exactly, a rise in the uncertainty premium associated with future price change expectations induces elements of fear and retrenchment in consumer behavior. One is also correct in presuming that

these inflation expectations would bear some relation to recent historical price changes. Current consumer buying patterns in the United States are consistent with this general hypothesis. Witness, for instance, the drastic reduction in automobile purchases that far exceeds the normal response to a rise in car and gas prices alone.

A similar set of conditions affect private business investment decisions, only the pattern is more complex. The immediate effect of an expected rise in the price of a product is to raise the discounted cash flow rate of return for potential investors in new facilities. As a consequence, if the basic cost of capital or so-called "cut-off rate of return" does not change, the arithmetic of corporate project analysis will create an immediate sharp increase in the number of profitable capital projects. The initial response to an increase in inflationary expectations would thus seem to be an increase in the physical volume of plant and equipment appropriations similar to our experience of 1973 and the first three quarters of this year. Eventually, however, the expectation of inflation will also become embodied in the inflation premium charged by lenders and hence in the nominal rate of interest and in the cost of equity capital. Because inflation expectations would eventually cause symmetrical results with respect to both the rates of return and the cost of capital it would appear that

capital expenditures in real terms would, as a first approximation, be invariant to the expected rate of inflation. However, an acceleration in expected inflation rates also produces an increase in the variability of price and cost expectations and hence an increase in the risk premium associated with those changes. Such risk premiums are additional to the usual risk associated with any investment project and increase the required target or cut-off rate of return. Consequently, real capital expenditures after complete adjustment will be below the level associated with lower rates of inflation. Although this process may be just beginning in the United States, it is already fairly far advanced in the rest of the world, especially in those countries where inflation has become endemic following periods of price stability.

Thus I believe it is clear that an increase in inflation expectations tends to increase risk premiums and reduce real effective demand both for consumer goods and for capital goods.

To the extent that expansion biased policies create inflation and gradually induce a corresponding rise in inflationary expectations, there will be a tendency for the Phillips Curve trade-off to deteriorate. This is equivalent to saying that a progressively decreasing proportion of any rise in nominal GNP is converted into increases in real GNP. Rephrased in policy terms: progressively more expansionary policies are

required to sustain any given low level of unemployment. At the extreme of such a progression is the case in which expansionary policies are no longer capable of reducing the unemployment rate.

However, implicit in a neutral policy stance or even a fixed package of expansionary policies is a presumption of declining real effective demand. Eventually, as slack opens up, there will be a decline in inflationary pressures, slippage in inflation expectations, a reduction in risk premiums associated with such expectations, and finally a recovery of real effective demand. In short, if expansionary policies do not become progressively accelerating the initial rise in inflation-based risk premiums eventually comes to an end and is reversed.

Unfortunately, the process of risk premium deflation has been aborted in the early stages of adjustment in recent years. Ratchet effects have thus been set up which have led to a progressively smaller share of nominal GNP increases being translated into gains in real GNP. As a consequence, ever larger inflation risk premiums have been engendered.

Once risk premiums generated by variable rates of inflation become a major part of private decision-making processes, their expurgation is not a simple task. For it is clear that reduced real incomes, which are associated with

persistently growing rates of inflation and the early stages of their decline, create a wholly new set of uncertainties and risk premiums. These are associated with rising concern with job security in the household sector and growing uncertainty in the business sector engendered by declining corporate profits and uncertainties with respect to future expected earnings trends. In the absence of any shifts in policy, we would expect that the period of declining risk premiums associated with gradually declining rates of inflation would be accompanied by rising risk premiums associated with declining levels of real income. These may be different types of uncertainties but their effects are the same on the household and business decision-making processes. Moreover, there is an obvious danger that the real income decline can become cumulative, as rising risks accelerate the downside pressures on economic activity.

Thus once the inflation genie has been let out of the bottle it is a very tricky policy problem to find the particular calibration and timing that would be appropriate to stem the acceleration in risk premiums created by falling incomes without prematurely aborting the decline in the inflation-generated risk premiums. This is clearly not an easy policy path to traverse but it is the path which we must follow. In principle, considering the usual lags in economic impact from policy changes, one

should eschew expansionary policies until the benefits from declines in inflation based risk premiums no longer exceed the cost of rising risk premiums created by weakening economic activity. Since the benefits may be longer in coming, but also more lasting, than the costs, this is, of course, no easy calculus.

This is the reason why we have always viewed the current stagflation as not a simple fight against inflation or fight against recession. Rather it presents the more fundamental problem of our balancing policies to bring the sum of two types of risk premiums back to the manageable proportions of earlier years. I realize that there are many who believe that the sensitive policy balancing act can somehow be made substantially easier by returning to so-called incomes policies. In our view this approach is illusory and merely attempts to mask and delay the underlying adjustment that is required.

A neutral policy, if followed until the economy has restabilized, is one way to proceed recognizing, of course, that the automatic counter-cyclical stabilizers are operating. Our judgement is that we are currently on the declining portion of the inflationary risk premium curve. But until the economy stabilizes the increase in the future income/layoff risk premium can conceivably more than offset the reduction in the inflation risk premium. The question is whether the increase in the income/layoff risk premium can be intercepted by a change in policy that would prevent a rise in the sum of both risk premiums. The danger

is, of course, that any effort to do so, unless cautious, would be interpreted as abandonment of the anti-inflation effort for some time. If so, this could set into motion a system of inflationary expectation patterns that would provide another step-up in the Phillips Curve. It is essential that we do not throw away the gains that we are in the process of making in reducing the inflationary risk premiums by hasty policy actions.

Having sketched out the broad problems currently confronting macro-economic policy, I should like to now explore the usefulness of the various policy instruments in confronting the type of problem we now have.

First of all with the possible exclusion of unemployment insurance, I would rule out any attempt to use Federal expenditures as a counter-cyclical policy tool. Pressures continue to mushroom under the vast numbers of programs which are continuously being created. The resulting uptrend in outlays is very difficult to suppress. In addition to the expansion of existing programs, new programs regularly devour the large fiscal dividends which are invariably promised three to five years out, but never seem to materialize. The normal workings of our government, both the Executive and the Legislative, create

a whole set of new programs every year just as a result of normal government procedures. One cannot say beforehand precisely what bills will be passed during the year nor at what cost, but recent history suggests a large unspecified uncontrollable which is strictly a function of the fact that our government meets and functions in creating new programs and initiatives virtually all year long.

Federal transfer payments in constant dollars have been increasing at more than twice the rate of total real GNP. This has been financed in recent years by sharp declines in real defense expenditures -- an area of the budget from which very little more can be taken. As a consequence, unless this trend slows down, we will either be looking at huge deficits with strong inflationary pressures or sharply rising tax rates required to finance the juggernaut of Federal outlays. In my view, the most Draconian measures applied to Federal expenditure growth are still likely to leave the rate of increase at too expansionary a level. If we are to prevent our expenditure acceleration from getting out of control, and there are those who think it already is, we cannot think in terms of expenditure stimulus, as a short-term expansionary tool for economic activity. As I indicated earlier, the senstitive counter-cyclical unemployment insurance payments

or similar counter-cyclical measures with self-correcting elements in them are quite different from the vast proportion of government outlays. Budget expenditure policy should be focused only on long-term considerations.

To the extent that the economic circumstances of early 1975 make fiscal measures appropriate, we should focus our attention wholely on the tax side of the budget. Rapid and timely action to reduce taxes is more feasible than expanding Federal programs. Moreover, there is a far greater possibility of being able to reverse the action in the future should circumstances warrant it, although the evidence here is rather mixed.

Monetary policy, of course, is a very sensitive and flexible counter-cyclical tool. There is very little I can add to the current discussion on monetary policy and even if I could, I shouldn't. I have avoided complicating this discussion by bringing in the obviously related considerations of micro-economic policy and the vast subject of energy policy.

I have tried this evening to outline some of the theoretical considerations which underlie our philosophy of policy and the types of macro policy instruments which we believe are appropriate for the problems confronting us. I have assiduously attempted to be as vague as possible on specific policy measures for fear of being interpreted as announcing some significant change in this Administration's

policy. The Council of Economic Advisers doesn't make policy. The President makes policy.

THE WHITE HOUSE

WASHINGTON

December 17, 1974

ADMINISTRATIVELY CONFIDENTIAL

MEMORANDUM FOR: ALAN GREENSPAN

FROM: JERRY H. JONES

The attached was returned in the President's outbox with the following notation:

-- Excellent -- as I said it did require a good bit of concentration.