The original documents are located in Box C29, folder "Presidential Handwriting, 10/13/1975 (1)" of the Presidential Handwriting File at the Gerald R. Ford Presidential Library.

CHARLS E. WALKER'S
WASHINGTON ECONOMIC REPORT

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Dear Subscriber:

In this issue we concentrate on trends in the economy--with special attention to the political implications--and the continuing financial problems of New York City. High Interest Notes cover wheat sales to Russia, and the further speed-up in the House Ways and Means Committee to report a comprehensive "tax reform" bill.

THE ECONOMY

If economic events of the past year contain any significant lessons, one of the most important is that the interested observer should take with a large serving of salt the day-to-day press reaction to emerging data on employment, output and prices.

Just a year ago, President Gerald R. Ford, responding to public and Congressional cries to seek a "quick fix" for inflation, held an "Economic Summit." But within a few months, press pundits who had trumpeted the need for the "quick fix" for inflation (an impossible dream) were castigating the Administration for worrying about inflation when, in their view, recession and high unemployment would constitute Public Enemy #1 for a long time. Indeed, many said, there was real danger that the recession of 1973-75, the deepest since the 1930's, would lead to an old-fashioned depression. Quite obviously, they argued, crash measures--including a massive increase in Federal spending and deficits close to the $100 billion range--were in order.

As to the strongly based recovery that has been under way since Spring, your editor recalls an informal debate with liberal economists and journalists at an Embassy luncheon in late May. When the host asked the guests when and if recovery would begin in the U. S., the liberals said "later"; we said that it had already begun. Revisions of earlier figures show that industrial production turned upward in May and, as has been well publicized, overall economic activity (GNP) showed a real increase of almost 2-percent (annual rate) in the second quarter. Therefore, even though many observers were at that time still predicting continued recession or late and anemic recovery, chances are good that the National Bureau of Economic Research--accepted arbiter of such matters--will place the end of recession and the beginning of recovery almost precisely in the middle of the second quarter, or the month of May.

Nor have the "roller-coaster" press analyses of emerging data ceased. The recent wide variation in the rate of increase in the consumer price index is a case in point. After consumer prices rose 2-percent between May and July (an annual rate of 12-percent), the press pronounced the return of double-digit inflation, implying permanency. Some economists expressed strong concern that the rising prices would drain off sufficient purchasing power to nip the recovery in the bud.

Now we have the August CPI increase, a modest 0.2-percent. But just as the double-digit increases of early summer were misleading on the high side, so is the August increase, at an annual rate of only 2.4-percent, misleading on the low side. As Treasury economists point out, the underlying rate of inflation, calculated after

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THE PRESIDENT HAS SEEN....

allowing for erratic factors, is still in the neighborhood of 7-percent. Which brings us to Council of Economic Advisers' Chairman Alan Greenspan and his "Three Sevens."

Politics and Economics in 1976. Recently, Greenspan emitted a "Three Sevens" forecast for 1976: 7-percent real economic growth, 7-percent inflation, both averages for the year, and 7-percent unemployment by year's end. Query: How reasonable is that forecast? And, if reasonable, what does it imply for Gerald R. Ford's election as President in his own right (or if Ford drops out for one reason or another, any Republican candidate)?

Not surprisingly, Greenspan's forecast has come under fire from the left, particularly those who would push for a forced-draft increase in aggregate demand in order to cut unemployment--and forget the disastrous inflationary consequences. But there is a more sophisticated attack on Greenspan's argument, one that is likely to result in a Great Debate on monetary policy and embroil the eminent Dr. Arthur Burns in even deeper controversy.

These critics point out what they believe to be a significant inconsistency between Burns' publicly announced goals of monetary policy and the Greenspan scenario. If, they say, Burns and his Fed associates intend to hold monetary growth to no more than 7 1/2-percent, then how is it possible to realize 7-percent increases in prices and economic growth in 1976? The two add up to a 14-percent increase in current, undeflated GNP. Given monetary growth of 7 1/2-percent, they argue, expansion in undeflated GNP at about twice that rate would require a massive increase in the "velocity" or "turnover" of money--the rate at which people spend (one dollar spent twice within a week has the same impact as two dollars spent once). Velocity usually increases significantly only as interest rates increase--but further increases in already high rates could have a severe dampening effect, particularly in housing.

To our knowledge, Greenspan has not answered this criticism. But chief monetarist guru Milton Friedman retorts that (1) the rate of monetary expansion has recently been far beyond the 7-percent figure, and (2) there is plenty of room for an increase in velocity, a contention bolstered by recent high savings rates on the part of consumers.

We lean toward the Greenspan-Friedman position (albeit a little uneasily), partly because of our deeply held belief that inflation must be brought under control, even at the risk of slowing the recovery and reduction of unemployment. But the gut political question is, will realization of the "Three Sevens" forecast be good enough to give Republicans a leg up on the "Pocketbook Issue" in 1976?

It's a close call, depending to a considerable extent on the configuration over time of the inflation and growth figures. If 7-percent averages for the year imply basically good performance from, say, June to November, with growth in workers' real take-home pay, then we believe the answer is probably "yes." As to unemployment, we believe that the relatively steady decline implicit in Greenspan's forecast is adequate for Republican political purposes (although the rhetoric will be hot and heavy). Rising unemployment, which threatens employed workers with loss of their jobs, is the major political danger. Declining unemployment, even from a relatively high level, may not be a strong political plus, but neither is it likely to be negative. Remember that falling unemployment also implies longer work weeks and more overtime pay, two factors which extend the benefits to the employed as well as the unemployed who find jobs.

Conclusion. If peace continues, the economy will occupy political center-stage from now until November 1976. In this respect, we urge again that you keep your eye on fundamentals and guard against reading too much into monthly swings in data.

NEW YORK CITY: A NATIONAL CONCERN

The financial problems of New York City will not disappear. Neither will they be confined to the five boroughs that constitute the city's legal area. It is too much to say that what's good for Fun City is always good for the country--but what's bad for the nation's leading metropolis can be bad for the country. And so, inevitably, Congress and the Administration are being urged to take a hard look at the problem and seriously consider Federal action. Thus far they've balked.

The Fallout from Default. More and more experts are swinging to the view that New York City will default on its obligations--according to Business Week, a "near-certainty" that may well "poison the well" for many other State and local borrowers. Moreover, a NYC default might pull New York state (and "Big Mac," the state-established corporation to bail out NYC) over the brink also. Many banks and investors, not just in NYC but all over would be hurt, both directly (from the New York default) and indirectly (from the fallout).

The ultimate financial and economic results are in fact unforeseeable, and the impact could come at a particularly delicate time--a Presidential election year in which the nation's economic policymakers face the difficult task of sustaining recovery without re-igniting the fires of double-digit inflation. And, as if that were not enough, sufficient other "crises"--including energy, the unwillingness of Congress to deal with the capital shortage, and the possibility that the corporate community will get zapped by forthcoming tax legislation--all this can add up to a "crisis of confidence" involving great danger to the bodies politic and economic.

It would be fine and dandy if the problems of Manhattan and its sister boroughs could be ignored in Washington. But that is impossible. And, indeed, a whole flock of proposals to deal with the NYC problem--some already introduced in Congress--are floating around. Among them, two of the more prominent are (1) outright Federal guarantee of all or selected State and local securities, including taxable issues; and (2) a Federal "Super Mac" to guarantee against losses of private insurers of State and local issues, as well as "Big Mac" liabilities.

Federal Guarantees? Outright guarantee of municipal securities by the Federal Government is flatly rejected by the Treasury, and with good reason. Given the privilege of tax exemption--a privilege not granted Treasury securities and not about to be taken away from State and local governments--Federal guarantees would convert municipal issues into instruments superior in quality to those of the United States itself. Neither Congress nor the Administration is about to approve this alternative.

Moreover, as Treasury Secretary William E. Simon points out accurately and forcefully, these safe, tax-exempt securities would preempt capital markets at precisely the wrong time--when we need to stimulate, not reduce, the flow of savings into productive investment.

Result: Scratch Federal guarantees of municipal securities.

Nor do we consider Federal guarantee of taxable municipal issues to be a strong possibility. This would be only one step removed from Federal guarantee of tax exempts, and, instead of centering on the type of short-run emergency aid that would be most suited to the situation, would commit Uncle Sam to support local governments for a long time--perhaps forever.

"Super Mac"? Several Senators have sponsored the "Fair Financing for Local Government Act of 1975" (S.2372). (The bill's title prompts one to wonder what's been "unfair" about local government financing in the past, especially with the valuable tax exemption privilege). While there are obviously several possible variations of the Super Mac idea, S.2372 provides a good vehicle for evaluating the proposal.

Super Mac would operate in two ways. It would offer insurers of municipal securities, public or private, "reinsurance" of 75-percent of losses resulting from failure of any locality to meet its obligations (Super Mac would be paid a premium for this). Second, Super Mac would guarantee a similar 75-percent of the liabilities of a Big Mac--a local assistance agency of New York or any other State. With private insurance of municipal securities covering only a very small part of the market, it is obvious that most of Super Mac's action would relate to Big Macs.

And herewith arises the same fundamental problem that dooms the direct guarantee approach. Insurance of 75-percent of the tax-exempt liabilities of Big Macs would create a security superior to Federal obligations. For the fact is that 75-percent insurance for any reasonably well-managed Big Mac would be tantamount to almost complete protection for its creditors.

(The Super Mac bill is also deficient with respect to the "strings" attached to guarantees--strings that are essential if State and local units which benefit from its actions are to be forced to take the bitter fiscal medicine that is absolutely essential for solution, rather than mere postponement, or their problems.)

Result: Scratch Super Mac.

Conclusion: Are the troubled cities therefore dead in the water in the Nation's Capital? Not necessarily. If they stick with either the guarantee or Super Mac approaches, their chances of gaining Congressional approval and Presidential acceptance are small. But if they turn their attention instead to tough measures that require supplicant local governments to partake of the bitter medicine of fiscal restraint--then they have a chance, but only a chance, of convincing the people in Paducah, Podunk and Pocatello that Uncle Sam should come to their aid.

HIGH INTEREST NOTES

Wheat Sales to Russia. Although not without shortcomings, a long-range government-to-government agreement for sale of wheat to Russia is better than what we've had--a secretive monolithic purchaser on one side versus an open, free-market arrangement on the other. One danger to be avoided is any tendency to establish a Federal marketing board for wheat and other grains, a system used in other countries but one unwanted by producers and buyers here--and one which, in our view, would work against the long-run interest of consumers. The other danger is that Russia will simply renege on the agreement when it's in her interest to do so. However, the erratic swings in Russian grain output should help militate against such action.

As to "bartering" our grain for Russian oil, the minuses greatly outnumber the pluses. Barter agreements are detrimental to the multilateral trading system to which the U. S. is dedicated. In addition, the U. S. already relies too heavily on imports of foreign oil. Needless to say, the Russians wouldn't hesitate to cut off the flows if and when they deemed it necessary to serve their interests. However, an alternative worth pursuing would be to "sell" some of our grain for oil to be stored as an emergency reserve in the U. S. This is clearly preferable to drawing down sharply our Naval oil reserves in California and Alaska.

Tax Reform. A tax bill that was moving along close to flank speed (see WER #17) has been moved by Ways and Means Chairman Al Ullman (D-Ore.) to an even faster track, with the scheduled completion date for preliminary Committee "mark-up" advanced from the 28th of October to the 9th. At this writing, the schedule of the Committee and the attitude of many of its members indicate a "no-win" situation for business in general and capital formation in particular. Despite the gravity and complexity of this latter problem, only one day--repeat one day--is scheduled for consideration of such important proposals as reductions in the corporate tax rate, liberalization of the investment tax credit, faster depreciation, elimination of double taxation of corporate dividends and so on. And the "single whammy" which is likely to result from little or no action in so vital an area may well turn into a "double whammy" when the Committee deals with foreign source income. Some members are determined to restrict the foreign tax credit (a device for avoiding double taxation of the profits of a corporation operating in more than one country), require payments of U. S. taxes on income earned abroad before the funds are paid out as dividends (no other industrial country does this), and eliminate Domestic International Sales Corporations).

Sincerely yours,

Charls E. Walker