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The President's Program

The big new factor in the economy is the President's program. The new program involves enormous changes, including tax incentives for investment, tax cuts for individuals, budget reductions, wage and price controls, a floating dollar, and an import surcharge.

The whole adds up to a very stimulative package in an economy that, despite press comments to the contrary, was well on its way to recovery from the very mild recession of 1970. The economy did not require as much additional stimulus as it has received and it is hard to see much relief from inflation in the total package.

The principal weakness in the economy has been the failure of rising retail sales to be translated into production. Much of the 8%-10% increase in spending during the first half went for imported items, especially autos but also TV's, tape recorders, and also industrial goods made abroad. In part, this was expected. Imports usually rise faster than exports in a recovery. But, because U.S. prices have risen much more than the prices of imports, the rise in imports was much greater than expected. While final sales rose at a rate not much different from other recoveries, domestic production lagged.

Floating the U.S. dollar makes imports more expensive and exports cheaper. A price improvement of from 5 to 10% against Japanese, French, British, Swiss and Italian competitors will particularly help American exports including food products, machinery, computers and the output of our high technology industries in direct sales and in sales to third countries.

Price and wage controls will have little effect on inflation. The longer they remain in force, the more irritation and inefficiency they will cause. This step seems entirely political -- to meet the rising public demand for controls and to beat one of the many Presidential candidates to the punch.

The problem for the administration now will be how to get rid of controls. There is no reason to believe that the rate of inflation is going to decline very rapidly. Until the government's budget and monetary policy get back to a less inflationary level, inflation will continue. The added stimulus in the program will help to reduce the government's budget deficit by raising profits and other incomes and therefore raising tax collections. Once this occurs, the deficit will decline.

The tax incentive for investment may not be passed in the form recommended. The 10% credit for investments made before August 1972 drops to 5% in August 1972. The incentive to accelerate investment spending so as to get the full credit of 10% becomes very tempting next spring and summer virtually assuring the President of a high level of employment in the months before election. An investment credit without the drop in rates next August will increase 1972 investment spending but much less rapidly and by smaller amounts than the administration proposal.

The 10% surcharge on imports must be temporary under international agreements. While it is in effect, it will have an extremely beneficial effect on those companies hurt by imports and not themselves importers.

Taken as a whole, and guessing that the rate of monetary expansion for the rest of the year is between 6 and 7% that the investment credit is approved but not in the form proposed and that the import surcharge remains in effect for only a few months, the program will be expansive. Short-term interest rates should rise as borrowing increases to build inventories and finance sales. Inflation will remain a problem.

A final comment:

The steel industry signed an incredibly bad agreement. Compare it with the auto agreement. In 1972 and 1973, the auto companies will have to increase wages by the productivity increases plus the rise in the cost-of-living index. They will neither gain nor lose from inflation if they can keep the productivity gains at 3%. The steel companies are going to pay 8% plus cost-of-living in 1972 and 1973. Until they discover some new magic that raises productivity by 8%, it is hard to see more than a continued decline for the industry even in an expanding economy.