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The JEC's Report: Reading Between the Lines

Early this year the Joint Economic Committee (JEC) of the Congress of the United States issued its Annual Economic Report. More recently the JEC released a Midyear Review. The main theme of both reports is the same: "that the Federal government needs to put its financial house in order and that major challenges today and for the foreseeable future are on the supply side of the economy." The shift in emphasis from demand management (creating additional total spending through Federal government deficits funded by newly created money) to the stimulation of production through investment and savings incentives ("supply-side" economics) has been favorably received by many economic commentators. In our view, a highly favorable response is unwarranted. While some progress toward economic sense is represented by the JEC's new approach, its supply-side economics is far from a cure-all.

During recent years, the JEC's annual reports have contained evaluations for Congress of the *Economic Report of the President* and have presented the Committee's economic policy recommendations. Until this year, the Committee's report was little more than a rubber-stamp endorsement of the President's policies by its majority members and a dissenting opinion by minority Committee members. This year, however, the full Committee has taken a position critical of the Carter Administration's budget and of the purported economic relationships underpinning the budget. According to the Committee, sufficient incentives to investment and savings are lacking in the Administration's budget. The economic policy endorsed by the JEC primarily emphasizes promoting productivity and creating jobs within the private sector. Increased investment spending by business firms would be encouraged through tax reductions, increased incentives to industrial research and development, and more reasonable and effective Federal regulatory systems. Thus, after nearly 5 decades of a pernicious economic policy based on manipulating aggregate demand by means of adjustments in Government spending and deficit financing, there finally is official recognition of the need for change.

Available data indicate that for some time productivity in the United States has been trending downward and recently has actually decreased. Measured by output per man hour in the private business sector, productivity decreased 3.3 percent from the fourth quarter of 1978 to the second quarter of 1979. The only longer period of consecutive quarterly decreases in productivity was from the first quarter of 1973 through the final quarter of 1974, when the average rate of decrease was 2.9 percent. From the end of 1974 through 1978, private business-sector productivity increased only 2.6 percent annually. This rate was less than the 3.0 percent average annual rate of increase from 1947 through 1972, and it occurred during the recovery and early expansion phase of a business cycle. Historically, the rate of increase in productivity has been greater during recoveries and early expansions than on average over many business cycles. The JEC's attention to the problem of lagging productivity and investment thus is appropriate.

Moreover, reducing tax and regulatory impediments to productive activity, the JEC concludes, will reduce the probability of continued slow economic growth, high rates of inflating, high rates of unemployment, and a declining standard of living. To increase capital investment, the Committee recommended: (1) reducing corporate profits tax rates; (2) expanding investment tax credits; (3) providing more rapid depreciation write-offs; (4) changing the tax laws and implementing other incentives to foster more corporate research and development activity; and (5) reducing Federal regulation of business when the benefits are small in relation to the costs. Consistent with these recommendations, the JEC's Chairman, Senator Lloyd Bentsen, has proposed: a $20 billion tax reduction to be split evenly between individuals and business firms; faster depreciation charge-offs; and tax exemption for some portion of interest earned on savings accounts.

These general recommendations and specific proposals sound "just like what the doctor ordered" to cure the slow-growth malaise of the Nation's economy. If the recommendations were accompanied by vigorous support for other measures necessary for sound fiscal and monetary management, this would indeed be the situation. However, the JEC reports ignored such considerations. Therefore, the JEC's new position can be seen not as a major "breakthrough" but rather as a first step away from the past pernicious policies that encouraged consumption and discouraged investment.

Not Too Big of a Step

Although demand restraint is widely viewed as an integral part of any sound program for implementing policy based on supply-side economics, the JEC asserts that the goal of increased private productivity and production must be achieved without a reduction in Federal spending programs such as those for promoting economic development and reducing structural unemployment. Indeed, the Committee recommends that an additional $400 million be spent for combating structural unemployment under CETA.

Additionally, the JEC, in its annual report, clearly supported easy monetary conditions: "If the aggregate demand pressures continue to mount in the months ahead, and if it is determined that these pressures are contributing to our inflation problem, therefore requiring a further policy-induced restraint on demand, the

additional restraint should come about through a tightening of fiscal policy, not through a tightening of monetary policy. Fiscal policy must shift to the forefront in the fight against inflation." But even this fiscal "restraint" is not to be too severe. Commenting on the foregoing recommendation, Congressmen William S. Moorehead and Henry S. Ruess said that if growth in real GNP falls below the annual rate forecast by the Administration for 1979 (2.5 percent) and if an easing of monetary policy proves insufficient for stimulating faster GNP growth, supplementary fiscal stimulus may be required. We are unable to see a significant difference between this view and the Keynesian notion behind demand-management policies of the past.

Further clouding the JEC's intent is their use of the phrase "fiscal restraint" to refer to a situation different from that of general economic usage. The JEC Midyear Review, published in August, asserts that although a policy of fiscal restraint is currently appropriate, the Administration's actual policy has become more restrictive than originally planned. The JEC estimates that the private sector is being taxed in excess of an extra $20 billion because inflating has pushed nominal incomes into higher tax brackets and has increased the Social Security tax bite. Rising nominal incomes and nominal corporate profits, according to the Committee, will add $12 to $14 billion to Government revenues, even assuming a rise in prices that does not exceed 10.5 percent. (The current rate is nearly 14 percent.) The additional Social Security tax attributable to inflating is estimated by the JEC to be $13 billion. This tax "drag" is the "fiscal restraint" referred to by the JEC. Curtailed Government spending or smaller Government deficits is not what the JEC means by "fiscal restraint." That, in our view, is a major defect of the JEC's new position, inasmuch as Government spending determines the amount of private resources expropriated by Government and larger Budget deficits usually foster more inflating.

The Committee's proposed *monetary* policy involves virtually no change from past policies. In spite of the obviously worsening effects of inflating, the JEC was more concerned about overly restrictive monetary policy: "We believe that the sharp dip in the monetary aggregates over the past few months [late 1978 and early 1979] was larger than desirable. It is our conviction that the Federal Reserve should allow the aggregates to grow in the ranges of their targets for at least the next several months." As we pointed out above, the Committee further recommended that if real GNP growth were to fall below the level forecast by the Council of Economic Advisors and more stimulus were needed, the stimulus should take the form of a more expansionary monetary policy.

The JEC treats the international role of the dollar with disdain in asserting that the primary role of the dollar must be to provide for the needs of the domestic economy and that diversion of the focus of monetary policy from domestic goals to the securing of international objectives, other than in exceptional circumstances, must be avoided. Opposition to restraining monetary expansion as a means of strengthening the dollar in foreign-exchange markets is clear in the report: "We should not sacrifice domestic expansion for the purpose of maintaining the dollar. Nor does it make sense for us to protect the export industries of Western Europe and Japan by deflating our economy when these countries could bring about a slower decline in their relative competitiveness by undertaking internal policies to step up their real rates of growth." This is the attitude that has created severe weakness of the U.S. dollar in foreign-exchange markets for the past 3 decades. It implies that countries practicing relatively sound monetary policies should inflate at the U.S. rate in order to allow the unsound practices of U.S. monetary officials to continue unabated.

The implementation of such policies was in fact forced upon German and Japanese officials in 1977 and 1978, and both of these countries recently have experienced unusually rapid increases in wages and prices. Although such increases have not dissuaded U.S. officials from continuing their excessively expansive policies, German and Japanese authorities view them with more concern. In both countries new policies of fiscal and monetary restraint have been implemented despite the probability that in the short run such restraint will adversely affect economic growth rates that are considered inadequate already.

Although U.S. money managers for decades have pledged to practice monetary restraint (as they did again on October 6th), they have yet to do so to a significant degree. Those who found great hope in the JEC's new emphasis on supply-side economics, characterized in some quarters as almost "revolutionary," must have ignored this major detrimental link to past policies. Perhaps the oversight is related to the JEC's not giving prominence to the monetary issue in its reports; in fact, the summaries made no mention whatsoever of monetary policy. Considering the questionability of this policy, we are not surprised that the JEC chose not to draw attention to it.

The Situation Is Not the Same

Investment incentives are not an innovation of the current crop in Washington. President Kennedy proposed a reduction of individual and corporate taxes along with an investment tax credit. His proposals were enacted during the Johnson Administration in early 1964, and the economy grew rapidly thereafter. However, the Federal government deficit had averaged less than $2 billion per year during the 4 years prior to enactment of the Revenue Act in 1964. The monetary base had been growing at an annual rate of less than 5 percent since 1960, and price increases averaged less than 1 percent per year.

Today's economic situation is strikingly different. Unsound domestic policies of the past decades have produced double-digit rates of price increases, huge Federal deficits, and excess growth of key monetary aggregates. The JEC's proposed plan to promote output and increases in productivity, and thus to stimulate economic growth, has a fundamental flaw. It fails to consider other economic arrangements that may be at least as important as taxes for the fostering of optimum economic advancement.

For example, as long as the Nation's currency unit depreciates, and especially if it depreciates at high and varying rates, price signals given by the market will be distorted. Consequently, uncertainty is heightened in connection with decisions to buy or sell, spend or invest, produce or liquidate, work or "loaf," etcetera. Such needless risk is greater the longer the time span covered by the decision. Inasmuch as saving, capital investment, and production generally involve a longer time frame than consuming and speculating, heightened risk discourages investment and retards economic advancement. Even when businessmen finally do make long-term investment commitments, the probability that the decisions will be unsound is higher because the price signals they have received may be false. Waste of resources and less economic improvement is the inevitable result.

Furthermore, a government of law rather than of men is required for optimizing economic progress. Congress may pass many types of tax changes in its zeal to promote production and productivity, but the potential benefits of such changes may never be realized due to the workings of an ever-growing and capricious bureaucracy. When bureaucracy grows, unpredictable laws are increasingly supplanted by unpredictable rules and unpredictability discourages long-term commitments, such as capital expenditure programs, employment training, and basic research projects.

The JEC fails to give due regard for the complexity of the U.S. economy. Few of the innumerable economic relationships are understood well enough to ensure that tampering with one sector will produce a predictable result in another. In manipulating tax bases and rates, Congress might foster results as distorted as those arising from past policies of manipulating aggregate demand. Money demand unmet by real supply cannot increase society's well-being, but neither can output unmet by real demand. Moreover, to have high economic efficiency, the total output must be of the items most wanted by society. Sound money, free markets, and reliable laws providing maximum freedom are the conditions offering the best chance of achieving a dynamic balance between supply and demand and of promoting optimum economic growth.

The JEC's new approach does represent some progress, but it is not the panacea for the Nation's economic malaise that some observers have implied.

GREED AND TULIPS vs. FEAR AND GOLD

A number of commentators, including Treasury Under Secretary Anthony Solomon, have connected the recent sharp rise in the price of gold with the Dutch tulipomania of 1634-36. In that flower craze, "The rage among the Dutch to possess [tulips] was so great that the ordinary industry of the country was neglected, and the population, even to its lowest dregs, embarked in the tulip trade."* Although some of the current commentators admit that the present demand for gold is more soundly based than was the wild demand for tulips in the 17th century, they warn that the ultimate result will be the same: namely, that many fools will be parted from their wealth for having purchased gold recently.

If anything should be clear from our writings, it is that we believe short-run gold price changes defy forecasting with an accuracy that enables one to profit consistently from trading on the basis of such forecasts. Therefore, we should not assert that persons who buy gold now could not suffer a loss. The price of gold almost surely will drop back from time to time, and persons who sell at those times after having purchased at higher prices will lose money. However, we know of no way to ascertain the specific level from which the price of gold will fall back or the price to which it will fall before rising again. Thus, those who sell at a particular price simply because there were earlier price increases might not again have an opportunity to buy at that selling price or a lower price. Indeed, some gold-oriented investment letters recommended sales and short sales of gold beginning in the high-$200 range. Followers of that advice thus far have not been able to buy gold again at such prices, and they might never again have that opportunity.

Missing from the comments about tulipomania has been a discussion of the difference between the motives of greed and fear and the implications of that difference for the recent surge in gold prices. These two motives – the desire to increase wealth (greed) and the desire to preserve wealth (fear) – generally are recognized as the primary reasons for decisions to buy or sell.

Obviously, greed was at the root of the tulipomania. Although tulips offer the reward of viewing beauty, the annals of finance do not indicate a fundamental investment role for tulips. When virtually everyone was trading in tulips, the expectation of profiting therefrom must have reflected buyers' hopes of finding a bigger fool to pay a higher price. Greed fostered price rises, which generated more greed. "At last," reports Charles Mackay, "the more prudent began to see that this folly could not last forever. Rich people no longer bought the flowers to keep them in their gardens, but to sell them again at cent per cent profit. It was seen that somebody must lose fearfully in the end. As this conviction spread, prices fell, and never rose again."

No doubt greed was responsible for a portion of the recent increasing demand for gold that propelled its price nearly straight up for some weeks, but we believe that fear was the greater motivation in this situation. The fear we are referring to is the fear of losing one's wealth from holding assets denominated in paper currencies rotting away at an accelerating rate. That fear, we suggest, is far from irrational. Monetary events of this decade fully justify it.

Seeking the safety of gold because of this fear, moreover, should not be equated with buying tulip bulbs. History is replete with examples of gold having protected wealth when assets denominated in mere promises to pay fell to a small fraction of their original value. Those who trust gold rather than paper almost surely will benefit in the long run from so doing, although in the short run they might have "paper" losses from time to time. For the price of gold not to rise in terms of paper currency in the long run, the general purchasing power of paper currency would have to stop decreasing. When one considers the chances of that happening, the idea that gold prices, like tulip prices, might fall *and never rise again* clearly becomes preposterous.

MANUFACTURERS' ORDERS, SALES AND INVENTORIES

Current downward trends in manufacturers' constant-dollar orders and sales and recent increases in manufacturers' durable-goods inventories are similar to changes in these series near prior peaks in postwar business cycles. These data support the evidence of our statistical indicators suggesting that the U.S. economy is in a recession that probably began in April.

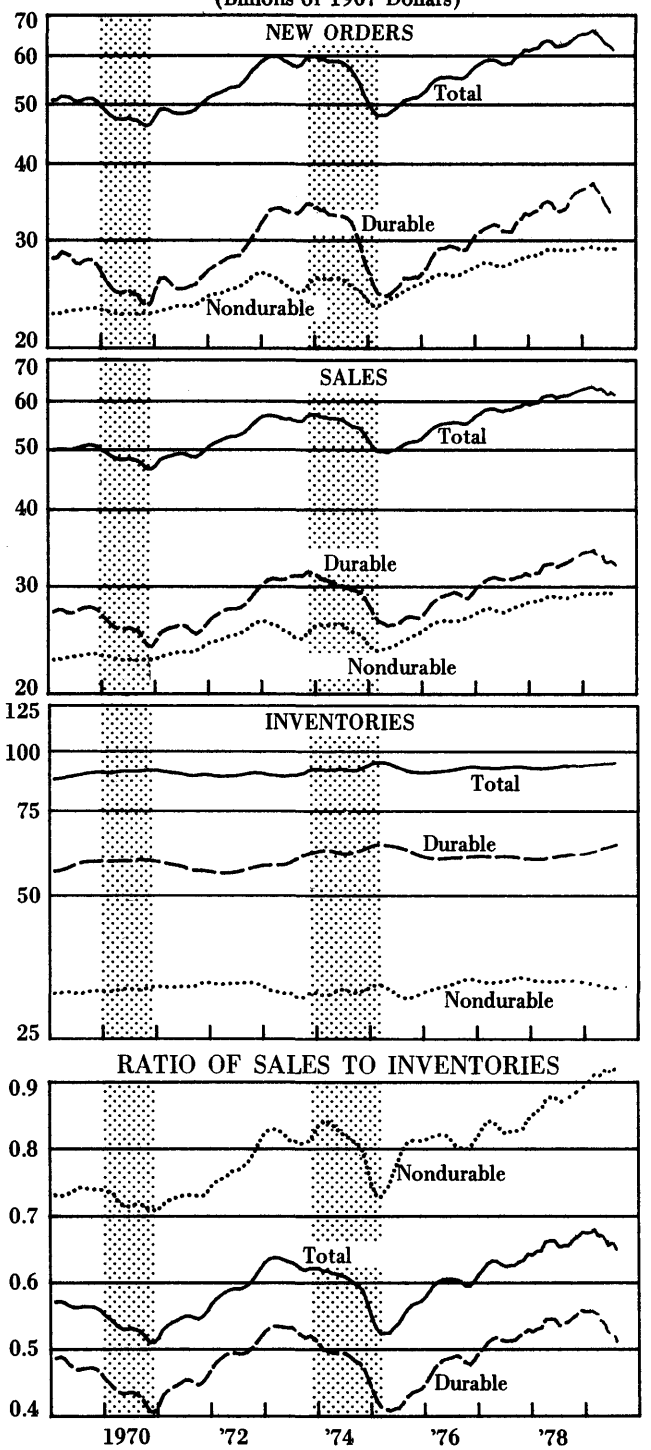
Note: All data are in terms of 1967 dollars and have been seasonally adjusted.

The accompanying series of curves shows the trends since 1969 in constant-dollar manufacturers' new orders, sales, inventories, and the ratio of inventories to sales. The shaded areas indicate periods of cyclical contraction of general business activity. Historically, cyclical changes in manufacturers' new orders tend to lead cyclical changes in general business activity, while trends in manufacturers' sales are nearly coincident with cyclical economic activity, and cyclical changes in manufacturers' inventories tend to lag cyclical turns.

* Charles Mackay, *Extraordinary Popular Delusions and the Madness of Crowds*, original edition 1841, second edition 1852, republished in 1932 by Noonday Press, p. 90.

As the accompanying chart reveals, manufacturers' "real" total new orders apparently reached a cyclical peak in the first quarter of this year. Subsequently, total new orders for the 3 months ended with May decreased at a compound annual rate of 6.3 percent, and for the 3 months ending in August, the rate of decrease was 16.6 percent. The decrease in total new orders was attributable almost entirely to a marked decrease in durable-goods new orders. Such orders fell at 12.9 and 26.6 percent annual rates, respectively, for the periods ended with May and August. As the durable-goods new orders curve shows, such orders account for the greater part of the volatility in total new orders and the magnitude of the current downward trend in durable-goods new orders is clearly the largest since the 1973-75 recession. Since the first quarter, decreases in "real" new orders for the steel, machinery, and transportation industries have led the decreases in durable-goods orders.

MANUFACTURERS' NEW ORDERS, SALES, AND INVENTORIES
(Billions of 1967 Dollars)



Note: All series are 3-month moving averages of base data.

When new orders first appear to be contracting cyclically rather than just temporarily, manufacturers still might produce at a continuing high rate for a time to meet accumulated unfilled orders, but soon they curtail production in order to prevent an excess accumulation of inventory. Especially will manufacturers be alert to inventory build-ups during coming months because of the current high interest costs of financing inventory.

Trends in manufacturers' real unfilled orders usually peak prior to the onset of a recession, but during the 1973-75 recession the unfilled orders peaked in the middle of the recession. The latest available data indicate that during the 3 months ended with August manufacturers' real unfilled orders changed little after increasing at annual rates of from about 15 to 20 percent during the preceding 9 months. Such a leveling in the trend of unfilled orders does not "prove" that a contraction in those orders is imminent, but it *might* be the first sign of an incipient contraction.

Total manufacturers' shipments (sales) during the 3 months ended in May and August decreased at 0.3 and 8.2 percent annual rates, respectively. A decrease of 3.3 percent in durable-goods manufacturers' shipments during the period ended with May accounted for the decrease then in total sales, but during the period ended with August, nondurable-goods sales also decreased. As with the trends for new orders, the recent downward trends in shipments, especially of durable goods, are larger than any temporary decreases during the expansion since 1975.

As the inventories curves reveal, inventories have begun to trend noticeably upward for durable-goods manufacturers. Such inventories increased at a 9.5 percent annual rate during the 3 months ended in August. The contraction of durable manufacturers' new orders suggests that this inventory accumulation was involuntary. With the prime interest rate at 15 percent, the cost of "carrying" such inventories is high and is a strong incentive for manufacturers to reduce output. This probably will deepen the recession.

The ratio of sales to inventories usually has peaked prior to cyclical peaks of the economy. This ratio for total manufacturers and for durable-goods manufacturers probably is contracting cyclically, which is consistent with the data presented above and with the status of the leading and coincident groups of statistical indicators.

PRICE OF GOLD

	1978	*1979*	
	Oct. 26	*Oct. 18*	*Oct. 25*
Final fixing in London	$233.70	$380.50	$391.80

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