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- Welcome once again as MIT professor Paul Samuelson discusses the current economic scene. This series is produced by Instructional Dynamics Incorporated. Professor Samuelson, near the midpoint of the third quarter, how does the recovery look?

- This is a good time to take stock. I have before me a series of the newest forecasts for the next year and beyond by the usual consensus forecasters. I have the brand new Wharton School forecast, the Albert Summers private forecast from the conference board, the new Chase Econometrics forecast, the new DRI forecast, and they all tell pretty much the same story, they all are fairly in agreement that we reach bottom some time around May, that we are now in the first year of a recovery. And I would have to say that by and large, the new batch of forecasts are a little bit more optimistic, a little bit more expansionary in terms of real growth, a little bit more sanguine with respect to the developments of the unemployment rate than the last ones. These consensus forecasters move, but they move like a glacier pursuing a reality as it develops. Now, you may ask are they, other than reacting to the fact that their hopes that we would have a turn seem now to have been confirmed? And I guess I would reply to that leading question, yes, they've taken courage, bottle courage you might say, from the fact that what they thought was going to happen has happened. But I would hasten to point out that that is necessarily irrational, that there is a great deal of momentum in any business cycle situation, and if you do finally get a peak at a turn in process, that should probably, rationally, lift your conditional probabilities. I used to say, you've heard me say it, that in the first year of a recovery, the consensus forecasters are sort of looking to six to seven percent real growth in the first 12 months after the middle of 1975, and for some policy makers, this ought to be a little bit on the low side. Of course, it's reassuring as against those who fear the continuation of the slide, and it's also reassuring as against those who thought that we were in for a very anemic recovery. I think if I were to take an average of all the different variants of the forecasters who's names I've mentioned, that the mean number now would come to at least seven percent. I testified before the joint economic committee not very long ago, and I was asked what a good target would be, and I this time chose the avenue of the moderation, and said that the seven percent real growth was a suitable target at this time. You may say is seven percent really a moderate figure? Well, let me simply reply that in the locker rooms that I frequent, it's considered a fairly modest thing and I've been berated if not reproached by some of my peers and colleagues that I didn't come out for eight percent and even nine percent. Well, a number of the forecasters have quarters, single quarters in the next four quarters, which in real terms are in the ballpark figure of two digits. Ten percent. The Ray Fair Model, which is a non-judgmental model, which compared to most of the names that I've mentioned, is a model of a few variables, it has a 12% rate of real growth in one of these last two quarters of the year, mostly due to the inventory turn around, kind of a slingshot effect, from the inventory deacumulation. We ought to take off our hat to that model, or we ought to take off our hat, because the model is now dying, this was its last forecast, professor Fair has I think been doing this more or less on his own, and it isn't so much that he's gotten tired of doing it on his own as that he is now working on a new model which he thinks is a better model. In his post-mortem, in his requiem eulogy of the Fair model, He said that in terms of its X-post forecasting record, that is if you put into the model, the correct exogenous factors after you know what they're going to be, and don't have to rely as he did on forecasting the exogenous factors from the unknowable, that it did pretty well. That it does as well as the X-post non-judgmental use of the more elaborate models. Hope that's not true, because it seems to me, and I say this in no spirit of criticism, that the Fair Model has been an extremely interesting experiment, but that it's been a disappointing experiment. It has shown us that without judgment, you do very badly in forecasting. I don't know how good the formal models are of the consensus forecasters, the Wharton model, the Chase model, the DRI model, but I do know that the people who massage those models, who adjust their constants, are quite well informed on what is happening. And there is serial, positive serial correlation and momentum and drift, so that you can extrapolate from what's happening, and so they do very much better. I would, for example, be inclined not on this occasion, but just in season and out of season to bet against that 12% number. It's just too big a shift in a short period of time. I think the Fair Model tells us something, a little, about the merits of big models versus small models. You know, you can have a model which is so big it just falls of its own weight. There was the famous social science research council Brookings model. It had some of the best Lieutenant Colonels, Majors, Generals, that we have in the econometrics army, but it was so big you could hardly test for its own consistency except for a run through the model. It was not good for short run forecasting and it was not good for long run forecasting. So some people said, what you really need is a two or three equation model. The Fair model is in that direction, and it has not, I think, done very well, certainly in X-anti forecasting. Which is what its main use has been. It's been discontinued. It's the same thing that's happened to the St. Louis Reduced Form Monatrist model. It certainly is simple in terms of number of equations, and it has done very poorly, even more poorly than the Fair model, and it too I think is now discontinued as far as published forecast. There is a new version of the equations which has been published by Dr. Lino Anderson, but I no longer get forecasts that tell me from quarter to quarter what's gonna happen to money GMP, what's gonna happen to real GMP, what's going to happen to the rate of increase in prices, and that's of course, what we would hope from a monatrist model. In the black book in which I keep all the forecasts that I learn anything about, I think actually the federal reserve bank of St. Louis has the largest squared error for the last half of 75, 74. The last half of 74 surprised everybody in its virulence. I think there's no exception to that statement. Nobody, even some of us who were on the pessimistic side say at the summit in September of 1975, none of us could foresee just how rapidly the economy would slide. But some of us had bigger squared errors than others, and it was from the federal reserve bank of St. Louis that of all the forecasts in my collection, both was respected a qualitative tone of the situation, and for the quantitative detail that was the largest in error. You can't prove anything by these simple little experiments, maybe if you continue them over many lifetimes, there will be, for the joy of judgment and eclectic discernment, a moral that will gradually emerge, but for whatever it's been worth, the experiment with the small models seems to have suggested that in this season, I mean now, the last three, four, five years, times when we certainly have been very desirous of getting good forecasts, they have done statistically, significantly worse than the other models. Well, we'll make of that what we can. The fact that the consensus forecasters have got their courage back and are looking for a fairly vigorous recovery, that same news, and that same feeling has spread through the country. The various indicators of consumer sentiment have shown a rapid rebound in consumers sentiment. The concern which was very widespread at the turn of the year, that the government wouldn't do anything about the deepening depression, not just recession, and that we would have a domino effect, slide into something like the 1930s maybe with some real epidemics of bankruptcy and even of bank failures, that concern has been soft-peddled. The pragmatic effect of all this of course, has been one of the most rapid percentage rises in the United States stock market that you can find in the history books, from the lows of last December until recent times, and the stock market seems almost like Moses, you remember that he could lead god's chosen people for 40 years through the wastelands, but when the promised land was in sight, it was not given to Moses to lead his people in, and he had to turn that job over to Joshua or Aaron or somebody or other. Well the stock market seems to be able to sniff at any impending recovery, and to make very substantial progress. But just as the fact of the recovery was confirming itself to the rational eye, the market began to move sidewards, and even to lose ground. It is a possible explanation, it's so simple that I hesitate to give it, but I think I can overcome my hesitation and give it. There is a view, a moralistic view, that in order to know whether stocks will go up or down, all you have to do is to know what's happening to interest rates. Particularly volatile, short-term interest rates. When interest rates go down, stocks will go up, when interest rates go up, stocks will go down. It's surprising how far in the last decade, that simplest view would carry you. You've heard me mention that I know some people in New York who ask my advice at intervals, and they operate almost exclusively in terms of this simple relationship. And I keep telling them, it's too simple, there are more factors involved than this one factor, and yet they so to speak laugh all the way to and from the bank, because it has done very well for them, and done very well for them at a time when very few people are doing at all well. Why did interest rates go down last fall? They went down because the economy was going to hell in a basket, at an unprecedented and unpredicted rate. Strange for the stock market to go down, to go up, when the economy is going down. Nigh impossible to provide an explanation, but at first blush, it would seem a little bit pickwickian or ironical. Similarly, why are interest rates now going up? That's a subject which I want to discuss in some detail. But certainly an important aspect of the picture is the fact that everybody now believes that the economy has made its recovery, that the slide is over. We're no longer sliding downward. And therefore, given the way the federal reserve maintains its posture with respect to the money market, this tends to create conditions which I'll describe in a second, which tend to tighten interest rates. Never the less, do you want to be smart? Do you want to be deep? Do you want to be understanding and perceptive? Or do you want to be rich? I'm of course, suggesting, because I really don't believe that the new formula, the new philosopher's stone has been found, that you can just blindly watch to see what interest rates do and then do the opposite with respect to stocks. But it is interesting that the stock market has not been able to make headway since the Dow Jones' peaked out at about 880, just at a time when the money market has convinced itself that the federal reserve is tightening up. The money market does believe this, and let me just read from the Salomon brothers weekly comments on credit. This one is written by Henry Kaufman, a name respected and revered in the money market. It comes at the end of July, and it's therefore not out of season yet. Comments on credit, Vigorous Monatrism is the title. "Through a dramatic series of actions, and the congressional testimony of its chairman this week," that's Burns, "the federal reserve gave notice to the market that it intends to pursue a much stricter monatrist policy than in the past." I think that adjective, monatrist is regrettable, because its a stricter policy with respect to the interest rates as well as with respect to just the money aggregates. "This means their attempt to hold relatively short-term trends in the monetary aggregates within moderate bounds, even if that means typing money market conditions in the earliest stages of economic recovery. Successive fed open market interventions this week confirm resoundingly that the authorities were raising their target for the fed fund's rate, which for some time had centered around 6%. On Monday," this is the last week in July, "the fed sold a substantial volume of treasury bills for cash, when fed funds were quoted 16% on Tuesday, they consummated reverse repos with funds at six-and-asixth percent. On Wednesday, authorities entered the market to provide reserves only after the funds hit six-and-a-half percent." Well, why is the fed moving its interest rate target upward? Undoubtedly, it's doing so because it has been somewhat frightened by what maintaining its previous lower targets seemed to be doing to the rate of growth of money supply. We had a rates of growth of money supply in short periods of time, which were 14%, in shorter periods of time which were 20% annual rate, and since the fed has given as its goal, under pressure of congress, congressional committees to get a goal that the money supply, M1 say, is to grow from five to seven-and-a-half percent in the period, or first they said for March to March, but now from the second quarter of 1975 to the second quarter of 1976, and since they were, as the economy was making its turn, and as the federal government was pumping money into the economy, at its peak rate, in the second quarter of the year, the annual rate of the fiscal deficit, if you use that as a rough measure of fiscal stimulus, fiscal deficit on the national income account, it peaked out at the second quarter at 100 billion dollars. It will be, would be a lesson then on a year's basis, and it's no coincidence that the turn of the economy was confirmed, the fiscal stimulus had something to do with confirming that in the face of an unprecedentedly large inventory deaccumulation. Well, the fed had realized that this would be a situation which would probably, unless interest rates were allowed or forced sky-high, cause a monatrist to have his hair curl, that it would be a very rapid short-term rates of growth in M1, and so they were prepared, as I remember it, for a number above their target of seven- and-a-half percent, the upper interval. But they weren't prepared for twice that amount, or even more, and so it kinda scared them, particularly since they know the monatrists are gonna be on their tail very soon, once those numbers get out, and nothing is new, everybody is on the federal reserve's tail, the economists who want a vigorous expansion complain when the federal reserve lets interest rates, short-term interest rates go up, the monatrists complain when they don't let them go up if the price of not letting them go up is to have increase in the money supply, and congress, now, is looking over if not the day-to-day activities of the federal reserve, certainly the month-to-month activities. I wouldn't say by the way, that congress are doing it in a particularly informed way, but we have only one democracy and we have to work with the democracy that we do have. Well, it'll be interesting to see how the recovery actually does develop in comparison with the average of all post-war recoveries and with the special features looked forward to by the forecasters with the best betting average. Let me just turn from the future, to mention something extremely interesting, the unemployment numbers as reported for July came in with a pleasant surprise. Let me just review, in May, the unemployment rate leaped up to 9.1%, and it was thought that that number had a bad seasonal correction in it, and was a little higher than it ought to be, so the punitive, genuine rate, if you had a good seasonal correction, was expected by experts to be in the ballpark of 8.9%. Mr. Julius Shiskin, the commissioner of labor statistics, who I must say has been conducting himself well among other things, very cautiously, at this stage of the game, he hasn't even to admit that there has been an upturn. Well, Mr. Shiskin warned us to expect that the June number would fall, and that wouldn't represent all that much of an improvement, it would just represent a correction of a correction, of something that needed to be corrected. While the June number did fall, and it fell perhaps a little bit more than he had warned us of, it fell from 9.1% as I remember, to 8.6%, but we could all say to ourself, aha, it's still consistent with 8.8, 8.9%, and people like me as when I testified before congress, said the unemployment has probably been lagging, so it's going to peak out a little bit above nine percent. But then, just a week or so ago, we got the July number, and the July number showed a further drop, not a rise, a further drop from 8.6% to I guess it was 8.4% in the rate of unemployment, and it was also a drop that in part was due to an increase in employment, not just an increment of discouraged workers, et cetera, et cetera. Now, the evidence is by no means all conclusive, because we have two ways of estimating employment from the sample of asking people and also from establishment data, and they show some disagreement. Nevertheless, it looks, now, as if it's a plausible hypothesis that the 9.1% number in May was the aberration, and maybe that'll be the peak of unemployment, and maybe unemployment is almost already on its way down. And of course, I think that's very good news, because one of the worst aspects of all the forecasts including the optimistic ones, has been that only very slowly do we bring the rate of unemployment down to eight percent, say some time next spring, and very slowly down to seven-and-a-half percent, say about the time of the election, November, 1976, and it'll be a long, long day on that scenario, until we get the unemployment rate even down six percent. But, you see now, it looks as if we have gained maybe as much as a half a percent in comparison with what were reasonably dire forecasts before, and I have to regard that as good news, after all, it is the unemployment which is the greatest human cost of the way we've chosen to fight inflation. I mustn't conclude without using the last minute to discuss inflation. Here, the consensus forecasters are really, fairly far apart. The hardest thing in the world for economists to forecast is prices. It's ironical. Chase is very pessimistic. Chase thinks that the rate of increase in prices will be eight percent, even nine percent, that this will feed into short-term interest rates and even into long-term interest rates, and is doing so already. On the other hand, there are students of the labor market, like Robert Gordon in Northwestern University, and Robert Hall, my own colleague here at MIT, who think with all this slack, that it is bringing down the rate of increase in wages and in prices, and I have heard from such people, I don't recall either of those two gentlemen, 'cause I haven't checked with them recently, that by the last quarter of the year, we might well see a three-and-a-half percent, four percent rate of price inflation. Along comes the drought in the middle west, along comes the bad crop prospects in Russia, and we're again, off to the races with respect to grain prices and with respect to food prices generally. So I think I will maintain my agnosticism that the rate of inflation will continuously abate, and that the recession has all been for good purpose and is achieving that good purpose. I think that we will do well over the next year, if we're able to keep the rate of price inflation, as measured by the GMP deflator or the consumer price index, in the ballpark range of five or six percent, not three, four percent, and I think there's a chance that it might well be that seven or eight percent, particularly if oil is decontrolled.

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