

- Hello, this is David Francis. Financial Editor of The Christian Science Monitor. I'd like to welcome you, on behalf of, Instructional Dynamics Incorporated, to visit once more with MIT's Nobel Prize winning Economist, Paul Samuelson. Some days ago, the government announced the statistics on gross national product for the first quarter of this year. Mr. Samuelson how would you say the economic recovery is progressing?

- If I can quote the poet, I would have to say that the winter of our discontent is over. And April is not the cruelest month. It is rather, a happy month. The first quarter numbers were pleasing in almost every respect. I noticed that in The Monitor, you ran a survey with the headline, "Economists elated as everything is coming up roses". Well, let's look at the garden and see if we can find some weeds or some posies to comment on. Of course, the striking big news was in the first quarter of the year, we had real growth in the economy at 7 1/2% annual rate. I can't say that, that's more than anybody had forecast, because Dr. Michael Evans of Chase Econometrics, some time before the news came out, forecasted exactly that number. So we have to give the loving cup for this quarter to Chase Econometrics. But Dr. Evans is a dedicated scientist, and he would admit that the 7 1/2% he forecasted and the 7 1/2% that happened, did have some differences. For example, he didn't realize, and nobody did, how much our balance of payments would deteriorate in the first quarter. We had a drop from a 22 billion dollar surplus, to a nine billion dollar annual rate surplus. And nobody quite foresaw that, although all the international trading economists I know, had been predicting that our recovery would undermine the surprisingly strong surplus which we were running, just a few months ago. You lose on the swings, but you win on the roundabouts. To compensate for the drop in our export surplus, came the news of a whopping increase in inventory accumulation. Most economists thought that we would go from negative inventory accumulation, that is, from the de-cumulation, which we were having, to small positive numbers, but nobody guessed that we would go to plus 14 billion dollars annual rate. The first little thorn to be found among the roses is the fact that, although the real growth of the American economy was strong in the first quarter, it was strong primarily because of inventory accumulation. And if you correct foreign inventory accumulation, as there is good reason to do, and calculate what's been happening to final sales, which is the change in the GMP, without the changes in inventory accumulation in the number, then you find that the first quarter was much less strong. In fact, it wasn't appreciably different from the fourth quarter. Therefore, when our enthusiasm tends to get out of bounds, we should remind us the fact that it's not a great thing to have a recovery which is depending upon inventory. Still...

- What does this mean for the current quarter?

- Well, I think that I have to agree with Citibank, which has said that you're unlikely to get a repeat of this magnitude. Therefore, the current quarter, the quarter in which we're talking, is not going to show a 7 1/2% annual rate, but it's going to show something less than that. Indeed, if inventory accumulation began to accelerate at this early stage of the business cycle, the Citibank would look upon that as too much of a good

thing, and would be quite concerned. And I would have to concur with that concern. However, mostly the picture is good. It was the consumer who led the way, leaving out the inventory matter. It was the consumer who led the way in the first quarter. And it was the consumer in automobiles, which is always a very important part of the American economy. Also, in non durable goods. Much, if not most, of the surprising inventory accumulation was in that particular sector. And since that sector got its house in order first, early last year, it's less ominous than would otherwise be the case. However, I've saved the other part of the good news, for now. The inflation picture came in, in a very pleasing way. In fact, too pleasing to be projected into the future. We had only a 3.7% annual rate of price increase, as measured by the overall GMP deflator. What does that mean for the consumer pricing index? Which I think most of us, and most of our families, consider to be the important rate of inflation. I believe that for the first quarter, that was an even better rate. Some optimists, I think prematurely are saying well, perhaps the Secretary of Treasury is lucking out and that we're on our way to 2% price inflation, as we move towards the end of the 1970's. And who knows, that as we move into the early 1980's, one can always dream, one can always hope, that we'll be on our way to stable prices. I would not advise you to hold your breath, however, because we know that the improvement on the price inflation side, can be associated with certain volatile food prices. No new bad news on the fuel front. OPEC has not hit us again with another whammy.

- I hear though, they're about to have another meeting in June that could provide a 10% whammy. (laughs)

- Yes, and this is a good reason to keep your fingers crossed. More ominous economists, more particularly Business economists, can always find something to worry about. If you look at industrial raw material prices, they've been climbing rather steadily, the many months of this year. The copper market is stronger, and a number of other such markets are stronger. As a result, the prudent thing to forecast, for the second quarter, for the third quarter, for the fourth quarter of this year, is inflation in the ballpark range of 5% or 6%, not in the ball park range of 4% or 3%. Nevertheless, let's rejoice while it's in season to rejoice. The first quarter numbers were very pleasing indeed, and Wall Street took due notice of them.

- What do you think this means for the Political scene?

- For the political scene, I've been saying on these recordings, that the incumbent president looks in pretty good shape, if the only factor you have to look at is econometrics. The poly metrics of econometrics are very favorable, for the president. I noticed that when the Business economists came together to vote on their consensus, that 79% of them, think that President Ford is a shoe in. Only a very small percent of them, think that Humphrey is the man who will be president. An even smaller percentage, think that Carter is the man to win. I have to conclude that I shouldn't over sell my own subject, which is Economics. I keep reminding myself that poly metrics is even less reliable than econometrics. The economy is doing very nicely, and I think that Mr. Allen Greenspan, the advisor to the President, is taking a little quiet satisfaction that things have worked out as he hoped they would do.

- You mentioned the stock market. What will this situation mean for the stock market?

- It's never vouchsafe to an economist what's going to happen in the future, with respect to the stock

market. The stock market, which has climbed again and again into the astronomic heights of 1000 on the Dow Jones, took a little spill sometime back because one of the technicians, like the poor whom we always have with us. The technical chartists we always have with us. And I think it was Edson Gould, this time, who gave a speech in which he expected the sizable, short-term drop in the stock market, and the stock market obligingly followed. But it was just a few day wonder, because when this good news on the economy came in, with some quite good news on the profile of profits. One of things which makes the stock market go up if it's rational is the profile of earnings. And earnings have been pretty good. In fact, let me pause a moment on what the trend of profits is. In the first place, the earnings have a better quality to them, because there is less paper inflation in these earnings, because there's less inflation in the American economy. In the second place, I've been commenting in these recordings for a long time, on the downward trend in the yield on capital, before taxes and after taxes, that seems to be discernible all over the advanced economies of the world. In Western Europe, in Japan, in the United States. However, there have been some new calculations, which suggest that if you correct for the business cycle, and just calculate the yield on American capital at 85% of capacity, so you standardize the 1975 performance which was below that par of capacity, that we have been witnessing a increase in the yield before taxes, of American capital assets since some time in the early 1970's. So one should always keep an open mind on a big issue such as, is whether there is a capital shortage or not. This is certainly one of the ways that a capital shortage would short sale. In a gradual improvement in profit margins, because this stuff is scarce, it's short and I think that, in a degree, this would tend to be good news for the stock market. Now, we don't want to get mired down in the pleasant contemplation of the stock market, but let's tick off a few of the forces, which seem to be important for anyone who wants to make his own judgment about whether stocks have already had it, and or now high, so it's too late to get in, or whether this recovery still has some life ahead. And it's not too late to add to one's stock market portfolio. My suggestion would be, that one should concentrate on at least two elements in the picture. One is what's gonna happen to earnings? Because what will happen to dividends can be predicted fairly accurately, if you know what's going to happen to earnings. But of course, in order to know the price of a stock, you have to know what kind of a price earnings multiple, what P/E, is put on those earnings. In order to think about that matter, one should concentrate on what's gonna happen to interest rates. There is no magic formula, in my opinion. I know I've said this here before, I know people who have the simple rule of thumb. When interest rates go down, buy stocks. When interest rates go up, lighten up on stocks. Because the P/E ratio, they think, will move in about the way, that bond prices move. If bond prices move down, because interest rates are going up, they think the P/E ratio for stocks will move down. High interest rates would be, other things equal, bad for the market. Now, other things aren't equal. One of the things that might push interest rates up is if the economy is doing so well and earning so well. I think you have to have at least a two-factor analysis, and that one factor is not enough. However, perhaps we ought to turn to what all this means, this strength in the economy. This rather cheerier picture, with respect to the next three quarters of the year for interest rates. You've heard me say, for a long time now, that I'm expecting short-term interest rates to go up anytime now. By and large, I've been wrong. I've been good company, because an awful lot of economists have thought the same thing that I have. On the other hand, there are some very good economist, I think of Henry Kaufman, whom I've quoted repeatedly, of Salomon Brothers, who has been putting early right in saying, not yet. That a sharp increase in interest rates is not in the cards, in this last winter that we've had. I think even now, he holds to that position. There probably was a little time, back in February when it looked as if the Federal Reserve was changing it's mind, and was

beginning to tighten up. It was becoming less friendly, and less permissive of the expansion. Something happened on one of the Thursdays and Fridays when everybody's watching the Federal Reserve reports.

- Yeah, a lot of people on Wall Street got fooled at that time.

- Yes, and then it seemed that maybe that wasn't happening. Then the explanation was, the Fed is accommodating Italy and the U.K., which are in trouble. And as apart of its Good Neighbor policy, and its responsibilities, its having a little bit easier money in the US than it really wants because it has to accommodate this avalanche that's taking place in the pound market, and in lira. So much for apparent fact, so much for clever penetrating explanation of apparent fact. We now have had the requisite number of days have gone by, of secrecy. Now, we know the true fact because they now tell us what they were thinking about. What they were aiming for during this period. And it turns out, that the clever explanation is not needed because neither before the international crisis were they intentionally tightening up, at that time. Nor, after the international crisis, were they modifying their tightening up behavior. They apparently were still rather steady as you go easy, according to all of the instructions to the Open Market Committee. Nonetheless, the people who think that there's gonna be an increase in interest rates, are like stopped clock that are eventually going to be showing the right time. It could be that, just about a week ago, when the money supply numbers, at the end of one week seemed to show a uplift. That was duly noted by the Market, and it was thought that the Fed was a little slow in resisting it, that historians will date the beginning of tightness from this time on.

- I see that Wall Street and the money market are still split as to whether the Federal reserve system is actually tightening up or not.

- Right ??? Every turning point, that's why it is a turning point, you're gonna have a division of opinion. And if you look at all the straws in the wind, half the straws are gonna look to be in one direction, and half in the other direction. What I try to do, in trying to guess what the Fed will do, is think, what would I want them to do. It's not the case, alas, that the Federal Reserve always does exactly what I want them to do.

- What would you want them to do? (laughs)

- I try to think, what should be the responsible posture of the Fed, at this time. And it seems to me, that whatever was responsible posture, three months ago, when the strength in this recovery was less apparent and less assured, that the Fed should now be tighter. I would suppose that Governor Burns and his associates on the Open Market Committee, are a little bit concerned as to whether this inventory accumulation is a premature blowing of the top, of the recovery. Which will shorten its useful and effective life. Even though they have this difficult problem that they've stated their targets, in terms of monetary aggregates, and the M1 aggregate. Ignoring the upward blip that I just spoke about, because one swallow doesn't make a spring, and it's too soon to judge how important that is. The M1 is still not within the range which they have been announcing and reaffirming each quarter for where it should be growing in the year ahead. The M2 is, rather comfortably, inside the range. In my judgment, there is room for the Fed to do a little tentative tightening up. My own counsel to them would be, don't be afraid to tighten up a little bit

prematurely, because you can always reverse yourself, and you should reverse yourself. The proper Federal Reserve policy is not to, for a long time go on one tack, like sailors heading into the wind, and then for a long time shifting over to another tack. The proper policy, any student of Optimal Control or Servomechanisms at the MIT Electrical Engineering Department could tell you, would be lots of corrections as you get more information. This is not fine-tuning. This is anything but fine-tuning. You do it this way, because you don't have exact knowledge about the probabilities. I don't think that it should ever be knowable to the Market, that the Fed is on a long, easing swing, regardless of how the economy responds to that. Nor, should it be in a position ever to know, that the Fed is on a long, tightening syndrome regardless of what happens. What the market should be able to know, is have some confidence that the Federal Reserve, looking at all the data that there are, using the best methods of analysis that experience has shown is available for understanding the passing economic scene, is always looking at the next six months, the next nine months and forming the best judgment possible, As to whether the economy is gonna be too strong or too weak in that period. Because we know that there are long, variable lags between what they do now and when the effects of their policies begin to show up. Therefore, if it's pretty clear to the forecasters with the best batting average, that the economy is heating up and come next Thanksgiving, after the election, we're gonna be in an over-exuberant economy. And we're gonna begin to get some shortages of capacity in certain lines of industry. Now is the time, to begin, on the part of the Federal Reserve, to prepare for some tightening up. What's appropriate policy, for the first year of the recovery, from last April Fools' Day, when you couldn't know, month after month, whether the economy had really turned the corner, and you couldn't know that it was performing at the bottom as now. I think the historian can say, with some confidence, whatever was appropriate policy then, is not necessarily the appropriate policy now. My own preferred goal, weighing the evils on both sides, has been for a 7% increase in real output, in this first year of recovery. I have to admit on what has taken place. I also have to admit, that I thought nine months ago that it would take a little more increase in the monetary aggregate. And little more ease, with respect to interest rates, than the Federal Reserve seemed to be performing. Since I really only want the 7%, I would have been upset, if the first quarter numbers had come in 8 1/2% and had that much stronger inventory accumulation.

- What about the budget? Do you think the administration and Congress are spending about the right amounts now-a-days?

- Well, the same logic, which makes me now prepared to countenance, a little more tightness in monetary policy, however you measure tightness, by interest rates or by the monetary aggregates, must, by consistency, make me be less anxious to second guess the President's numbers. By an add-on of some 10's of billions of dollars. I think that The Treasury is gonna find itself with better tax receipts. I think that the states and localities are gonna find themselves, because the economy is stronger, with better tax receipts than they thought. I think that the rather pleasing performance, with respect to employment increase, which we hadn't commented on but is apart of the same picture that we've been discussing, will mean that some of the aid programs, which were appropriate when the economy was bogged down, are not so appropriate. I would, for example, look with skepticism on any big Public Works program started as late as now.

- It wouldn't get into effect in time.

- It would get in effect only in time to overheat the economy when this boom is beginning to show some raggedy signs of old age, so I think we would have trouble.
- One last, final question, would you say this has been an ordinary recession and recovery, and an ordinary business cycle, or is there something unusual about this business cycle we're coming through?
- I would say, one must realize that the recession, which preceded this recovery, was, by post- World War II standards, a recession of considerable virulence, considerable amplitude and duration. And, it was one that was, by and large, not naturally created, but created to fight inflation. Given the length of duration, and the amplitude of the recession, I have to go along with Geoffrey Moore, who says you could expect a more serious rebound from a more serious recession. I would say the rebound has been extremely healthy. It's not been a natural recovery, because it was helped by fiscal policy and responsible Federal Reserve policy. I'm using all the ways you can measure Federal Reserve policy, not just the monetary aggregates. I think the problem, from now on, is to make this a long, sustained, lasting recovery, like that of the 1960's, from 1961-1966; rather than the short, choppy recoveries like that of the 1950's.
- Thank you very much, Dr. Samuelson. If you subscribers would like to ask questions of Professor Paul Samuelson, or suggest subjects for him to discuss, please write to Instructional Dynamics Incorporated, 450 East Ohio Street, Chicago, Illinois 60611.