
- Welcome once again as MIT professor Paul Samuelson discusses the current economic scene. This series is produced by Instructional Dynamics Incorporated. Professor Samuelson, it's been a while since we've asked you for an assessment of the general business scene. As you see it, where do we stand right about now?

- Now that we're in the fourth quarter of the year, things are looking pretty good. Indeed, perhaps they're looking too good. Since last we talked about this general economic outlook, we've received the preliminary estimates of what happened during the third quarter of the year. The third quarter of the year was expected to be strong, in part because there were leaks concerning the strength of the third quarter coming out of Washington from the top, from the bottom, from the middle, for about a fortnight before the first estimates actually came out. It's something that troubles me a little bit. I like to have the news, whether it's good or whether it's bad, come out at the first correct time for it to come out, and I don't like an early peek when the news is good and any cover-up when the news is bad. I think that in the long run, the government stands to gain from playing the matter straight. But this is a very small and unimportant detail. In the event when the announcement finally came as to what had happened in the third quarter of the year, it turned out that the best estimate the Department of Commerce could make on the basis of its preliminary numbers was that the American economy was growing and was growing very vigorously indeed. It was growing in the third quarter of the year in real GNP. That's the money value of all goods and services corrected for the rate of inflation at an annual rate of 11.2%. That is a high figure. It is not an unprecedentedly high figure for the first quarter of recovery from recession, but it's right up there with the very strong rebounds. In fact, it's consistent with the bottom interpretation of the lower turning point. That's the real number. On the side of price inflation, the news was, I think, also quite good. The overall price deflator for the third quarter was estimated to be increasing - that's our rate of baseline inflation - at about 5% annual rate. That may be a little bit misleadingly favorable because some of the shifts in weights within the quarter were towards goods which show a lower rate of inflation than other goods. And therefore it's of interest to look at what happens to the so-called chain index deflator, which is an index number of how prices in general are behaving, but an index in which there's a fixed set of weights. So you just simply take an average of all price changes on an annual rate basis, weighting them with fixed weights, and that's a bit worse than 5%; it's 7%. But still, I think that one must say that this is a sizable improvement over a year ago, and it is a bit of improvement over what we had begun to fear at the time of the Russian grain deal when the food prices were rising, when wholesale prices were again beginning to rise, and when one had a reasonable concern that in the last half of 1975, the price deflator might begin to rise at an 8% or even a 9% annual rate. Things did better than that. The physical index of production of the Federal Reserve is also showing a very healthy snapback. Now, was this expected? I don't think so. The forecasters generally had been moving up their third quarter estimates. I'm looking at a particular forecast from one of the sources that I've been quoting from often on these cassettes, and this one was prepared as recently as October 8th, 1975. And it expected the third quarter to show a increase of only 8%. Well, only 8%, that's strange words to use for so healthy and respectable a rate of growth. But since the actual estimate is 11.2%, you see, there was a good strong 3% above this. Now, why did I say that the news is almost too good? I think that 11.2% maintained for several quarters in a row would be a faster rate of recovery than is good for the economy. I know there's a sense in which one is tempted to say that with unemployment still so high, in the third percent at the last census, you can't grow too quickly because you've got an awful lot of slack in the system anyway, and until you get the unemployment rate down to 7.5%, to 7%, to 6.5%, to 6%, you don't have to worry about demand-induced wage increases or demand-induced price increases. Well, I'm afraid that that argument is probably over-simple, and the rate at which employers are adding to their working force may be an independent component which puts cost and supply pressure on the rate of inflation. What most of us would prefer is a long recovery at a vigorous but not over-vigorous rate. I used to say 7%. Well, I wouldn't object if we grew for several quarters at an 8% annual rate. But I'm reminded of what happened in 1972 when we had a quarter or two at double-digit real rates of annual growth, and that was at last followed by the recession. So let us hope that this strength is an omen of good things to come, but that it will correct itself. If one looks at the composition of the GNP in the third quarter, I think there are some grounds for believing that it's not the best guess to project into the fourth quarter and into the first half of next year a continuation of two-digit annual rates of real growth. Mind you, I don't think of annual rates of real growth in the two-digit area as the sort of catastrophe which two-digit accelerating price inflation is likely to be for a mixed economy like ours, but you can have too much of a good thing. The single factor which accounts for the extreme strength in the third quarter seems to be inventories. It was inventories, you will recall, which by decumulating at so rapid a rate at the turn of the year, for example in the first quarter of 1975, that gave rise to the strong decline in real growth. And so it was only to be expected that when the extreme rate of inventory decumulation began to taper off, as it was confidently predicted it would, that this would give you some relief and in fact cause a turn. And that certainly did happen. I believe that history will judge that the turn came in April. But suppose that history judges that it came in May. That's a very small difference in time. It came when the rate of inventory decumulation continued to show decumulation, but at not so rapid a rate. Well, it appears that in the third quarter, we still are decumulating inventories, but not everywhere, and many parts of the economy are now trying to accumulate inventory and in a measure succeeding. You have heard analysts speak of the distinction between real GNP growth and final real GNP growth, that is, the growth in final demand after you purify the numbers of all inventory changes. The final demand has not been as strong in the third quarter as is indicated by the total 11% of real GNP, and I suppose that's one of the reasons why most of us think that the fourth quarter of the year will show some letdown from this very high rate. But nevertheless, the basic indicated strength in the recovery to come, I think, must be written up a little bit by virtue of the third quarter estimates. We've learned from experience, from sad experience, that the first estimates of GNP often have to be revised. And it has seemed to me, in monitoring this process, that very often they are revised in the direction of removing the surprises or part of the surprises that were in the first estimates. And so I guess if I were forced to make a little bet as to whether the real growth in the GNP in the third quarter turns out to be a little bit less than 11.2% or a little bit more, I'd rather be on the less than side. But there'll be many an occasion when using that betting strategy would have lost for you your money. So I think we have to take the figures as they are. They don't include the September inventory numbers because there's always a delay in the receipt and processing of those data. And we may find that that will change the picture. But it's my impression that the general September picture is confirmatory of the story that was being told by the first estimates. There are some surprising aspects of this. Inventories, after all, are a volatile item. They are hard to predict. It was just a little while ago that a couple of our best forecasters were saying that we're not going to have inventory swings anymore in the American economy. Famous last words. Because of the computer, because of advisory services like the ones that I'm quoting from, American business has learned not to panic. It's learned how to control its inventories. Therefore, it won't go through the same rollercoaster. Well, you'll recall that for a little while, the Department of Commerce seemed to be confirming that explicit hypothesis and prediction, but then the Department of Commerce revised its earlier data, and it turned out that there was a lot of inventory decumulation, and similarly, there is a unpredictable element in this. It may be that we'll pay in weakness in subsequent quarters for this strength. This strength is borrowing from the future. But it may also be the case that there is something going on in the American economy which the seismographs of the analysts had not earlier picked up, indicating greater baseline strength. What I think is a bit surprising is what's been happening, at the same time that the economy has been so strong, to the rate of growth of the money supply, what's been happening to interest rates. It would not be out of line with past experience that in a third quarter, where the real growth startled everybody by its strength, that the money supply at the end of the quarter, after we learn what happened to it, would turn out, despite the attempts of the Federal Reserve to be within a given range, say, 5% to 7.5% annual growth rate in M1, checkable bank deposits and currency. It would not be surprising, given that strength of the economy, if the money supply should run ahead of that target. That often happens. If the Federal Reserve behaved in an automatic fashion, recommended by many monetarists, it would happen less often, although even then it might happen occasionally. But the Federal Reserve behaves only partially in the fashion beloved of the monetarists. It does keep the money supply steady so long as unpleasantly large changes in the interest rates are not the consequence of such a tactic. And when the interest rates tend to rise because the economy is racing ahead, and the economy, so to speak, seems to need more money to finance its extra strength, then the Federal Reserve acts to modulate, to moderate, to hold down the increase in interest rates, although not to hold that increase down to zero. And under those circumstances, following that mixed strategy of both trying to stabilize the interest rates and trying to stabilize the rate of growth of the money supply, the result is that you fall somewhere in between each of those, and it results in a reverse causal direction between business activity and the money supply. In other words, part of the increase in the money supply, under normal patterns, is a response to the strength in the economy or the weakness in the economy. This, of course, means that if somebody naively applies simple correlation, or even if someone naively applies multiple correlation without making the appropriate adjustments for what I've just spoken of, he will misidentify the true causal relationship between contrived changes in the money supply by the Federal Reserve, and the real business economy and the price level. I don't have the time on this occasion to go into that misidentification, but it's very understandable because of the work, in part, of Professor Koopmans, whom I talked about last time because he shared the 1975 Nobel Prize, but it goes back to earlier work by Professor Ragnar Frisch of Norway, now dead, who was one of the co-winners of the very first 1969 Nobel Prize, and his student and disciple, Professor Haavelmo of Norway. If you have a supply and demand curve, and fluctuations in the rate of harvest are shifting the supply curve alone, then the shifts in the supply curve will trace out a scatter of prices and quantities which fall along the demand curve. And by simple correlation or sophisticated multiple correlation, you could hope to measure the elasticity of demand quite accurately. And the late Professor Henry Schultz of the University of Chicago, in his masterful Theory of Measurement of Demand, tried to do that. But suppose that at the same time that the supply curve is shifting, the demand curve is also shifting. Well, if the demand curve alone were shifting, you'd trace out the supply curve, and you might correctly get the positive elasticity. Well, I've given you two cases, one where you might correctly get the negative demand elasticity, and the other where you might correctly get the positive supply elasticity. Suppose that both of these processes are going on at the same time. Then what you get is some weighted average, some compromise between the negative demand elasticity and the positive supply elasticity, and that tends to give you a zero elasticity, a very inelastic estimate for, well, you say demand, but it really isn't a correct identification of demand. Well, the same thing happens exactly in the field of inductive inference concerning how much truth there is or isn't in the usual monetarists' equations. Well, all of this is an elaborate prelude to the surprising fact that instead of having M1 being extraordinarily strong in this third quarter, it was extraordinarily weak. I have before me an end of October Argus weekly staff report. This is put out by the Argus Research Corporation, a macroeconomic analysis for brokerage concerns and for banks. I have quoted from it before because it's well worth quoting from. There used to be some eminent monetarists who worked for the Argus organization, and most of those known to me personally are no longer there, but they seem to have worthy successors. And they have some very interesting graphs showing from the second quarter on growth rates in the money supply with the shaded area indicating the 5% to 7.5% target for M1 and the 8.5% to 10.5% target for M2 and the consistent credit proxy targets that goes with that. And what's very interesting is that M1 has dipped below the shaded area of the official target. M2 has moved sideward, and since the shaded area moves upward, it has finally moved out of the shaded area. And the credit proxy is very definitely out of the shaded cone appropriate for it. This, of course, has been noticed by the marketplace, and the marketplace has taken this to be a good sign. A good sign of what? A good sign that the rate of growth of the money supply is gonna be increased by the Fed very soon, that the Fed is going to insist upon and is going to succeed in getting easier money. And as a result of that, we have for many weeks now been in a lowering of interest rates, a lowering of interest rates which was predicted by very few of the analysts whose predictions I monitor. Of course, there's only one surprise. The moment you get the surprise of what's happening to the monetary aggregates, then all else follows with respect to interest rates, the stock market, and all the rest. I don't know how to explain this. One can say, "Well, the velocity "of circulation of money has surprised us," but that is simply reproposing the problem. Why did the velocity of circulation of money surprise us at this stage? It's customary for the velocity of circulation of money to go up in the recovery phase of the business cycle, but it goes up along a schedule of rising interest rates. And the effect we're talking about was with unchanged interest rates, the velocity of circulation of money went up. So we have a residual that does need to be explained. We also have some perversity here. The Federal Reserve, the monetarists, and many people in the marketplace who say, "I'm not a monetarist. "I don't agree with the Federal Reserve. "But I think that the monetarists "do have lots of influence, and I think "the Federal Reserve will behave "the way it always tends to behave." Well, a lot of such people, and I share some scientific empathy with them, would argue cogently, I think, in the following way. Let's suppose the third quarter is very strong. Let's suppose that looking ahead three months, six months, nine months, there may be more strength in the economy than had previously been allowed for. The logical policy conclusion from this would be that if all this could happen with a rate of growth of the money supply below the target, and if we have any confidence in that continuation and impending strength, then this would be a good time to go below the monetary target. I don't believe in being biased always in one direction rather than another. I think you should be in the correct direction that's neither right nor left. And so the Federal Reserve ought to be thinking very seriously about whether it should not now be holding down the rate of growth of the money supply in line with what's happened in the surprising third quarter. By that, I mean it should be thinking that as long as it has reason to extrapolate ahead confidence in the strength of the economy.

Instead, it and the monetarists and all of us in the market who want to make a nickel in guessing what this philosophy will do, whether it's a good philosophy or a bad philosophy, are saying odds are that the rate of growth of the money supply will atone for its moderation in the third quarter by being very strong in the fourth quarter. And already we've seen a reduction in Reserve requirements. That's a strong signal by the Federal Reserve that it wants to have a more rapid rate of growth of the monetary aggregates and wants to have some easing of interest rates. We've had a cut in the prime rate. This is the first cut for a long time after the prime rate had begun to move in the opposite direction. And we've had, in the face of some really quite adverse and depressing news from New York City about the likelihood of default, with all that that implies for adjacent dominos in the municipal market, New York state bonds, for example, Massachusetts and so forth. Despite all that, we've had a pretty good stock market, pretty good strength in the stock market. Well, now this all reveals a moral, namely, what it is that is the best policy to pursue in the next four weeks for the Open Market Committee, or in the next three months for that same Open Market Committee, must depend upon the reasoned indications of the strength or weakness in the economy. You may stick to a middle figure because you have no confidence in your own forecasting, and there are a number of monetarists who have a good deal less confidence in their forecasting than they did a few years ago, but that itself is a forecast about the absence of discerned strength or discernible weakness. And if everybody could agree with that, then that would be the reason for moderation in the money supply, not that moderation in the money supply, in and of itself, is a good thing. Well, one last remark. The strength of the recovery has received very little help from housing. In fact, we've had a drop in housing starts. We were beginning to get some disintermediation. But it did get some strength from autos. And I've been warning on these cassettes and in my various forecasts wrung out of me in lecturing that housing is not an easily predicted variable. And just as it was very weak all last fall and through the turn of the year, there's a very definite possibility that it could be strong, and that seems to have been the case for the last couple months. And it's something very much to watch because even though some of the consumer sentiment indexes were not all that exciting, not all that buoyant, you are finding at the dealers that the '76 models, both domestic and imported, are being received pretty well. And that could spread into other areas too.

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