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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.

- The third quarter has ended, and we don't yet know what the real growth of GNP was in the third quarter. But the estimates have been coming in, and I think it's fair to say that with each passing month of the third quarter, they have not been going lower. If anything, the consensus forecasters have been tending to raise their estimates. Just to give you one straw in the wind, a straw that is not in the middle of the range of the consensus forecasters, it's a little bit extreme, but it's an interesting straw. Let me comment on the report on the recovery that was issued by the new Congressional Budget Office. The Congressional Budget Office is an innovation in our system of government. The Federal Reserve has long had a career staff at the call of the Federal Reserve Board, and at each Open Market Committee of the Federal Reserve Board, prepared to lay out for the Open Market Committee what have been current trends, and what are the likelihoods with respect to future trends? Every important agency in the Executive also has a macroeconomic monitoring research staff. Of course, the Council of Economic Advisors. the Treasury, the Bureau of The Budget, Office of Budget and Management. These constitute the so-called troika who meet and determine, for the President, what his policy options are. Congress has been at something of a disadvantage in this adversary procedure. It could sit and have hearings, and an occasional congressional committee, like the Joint Economic Committee, might have an in-staff set of macroeconomists who occasionally did forecasts. But the Congress at large has not had access to expert opinion. And so the Congressional Budget Office was set up with Alice Rivlin, Dr. Alice Rivlin, a distinguished economist who's served a tour of duty. I think it was in HEW. I believe it was during the Nixon term. She was previously just most recently at Brookings. She's a very respected figure, not only gave a great deal of joy to those who've been concerned that career women in the professions get a fair shake when Alice Rivlin was appointed, but on her own merits there was a great deal of approval for this. And she has assembled, in remarkably fast time, an excellent staff. As somebody has said she landed running, and they put out a report in June, and they put out another report in September. And periodically, they will outline for the Congress, what the various policy options are. Their inflexible rule is not themselves to make any policy recommendations. And I hope they stick to that rule, because the more liberal half of Congress, I think welcomes the Congressional Budget Office, and the more conservative half of Congress is a little bit doubtful. Dubious as to whether this is or isn't a good thing. The last thing in the world that the conservative half of Congress wants is a Brookings Institution inside of Congress. They don't want a bunch of technocrats, members of the Galbraithian Technostructure, who tell them what to think and what to do, and push them around. Now, I take it that whatever one's persuasion as a legislator, having information available on what's happening, and having analysis of what experts across a broad spectrum think, are the likelihoods that will happen from different policies is going to help one rather than hurt one. Unless you have a very weak case, so that ostrich-like, you wanna keep your head in the sand and not know the arguments against your case. I will hope that ultimately, the Congressional Budget Office will turn out to be the good right hand as well as the good left hand of Congress. That's by way of preamble. Now, what did they put out in their report early in September? They said that the economy in the last half of 1975 looks to be very strong indeed. In fact, their point estimate number under present policies is 8% real growth in the third quarter, just behind us, and 8% growth, annual rates, of course, seasonally corrected, once again in the fourth quarter averaging 8% for the last half of the year. When the report came out early in September, this was considered to be rather an oddball viewpoint because they were one or two percentage points above the consensus forecasters. However, it now looks as if they've got a fair chance of being right in the third quarter. For one thing, the second quarter data had been revised upward, so we start out from a springboard not of a small minus rate of growth in the second quarter, but about a 1.9, call it 2%, annual rate of growth in the second quarter. And to add 6% on top of that in one quarter isn't quite the stretch as to add something more than 8% would be. Furthermore, there is reason to think that autos have been strong in the middle of September. Middle 10 days, first 10 days of September. And auto sales, of course, are a very important tail that helps to wag the dog. And, as a matter of fact, the tail in this case constitutes part of the poundage and structure of the animal. We have to be careful. This year, General Motors is permitting its automobiles to be sold before their official introduction date. That was not true last year. Last year, there was a bulge in August. And in September. It was a bulge in sales of domestic old model year cars as people rushed to jump the gun to buy at the lower prices of the old model year. But also, even-steven at the same price, they didn't care for the new model year cars last year. The new model year cars, they thought, like the new model years for so many years now in this pollution-conscious age, would have more and more gadgets and guck on them, which would improve the atmosphere. There's some evidence that the pollution controls have worked reasonably well, in fact surprisingly well, in helping with respect to most components of atmospheric pollution. But they have done this somewhat at the expense of gasoline mileage and efficiency of operation. However, the new American cars show now a great improvement in gasoline mileage, and the stories, I won't say the fictions, that can be told about them are also very pleasant to hear. The General Motors has introduced a very small Chevrolet, the Chevette I think it is, which is comparable in its claims with the claims of the small foreign cars. If you take a Japanese Honda as the ideal small, light car that produces almost 40 miles per gallon on certain test dynamometer conditions that simulate what happens in the open highway, well, the Chevette does 40 miles per hour. And that means that under conditions that simulate city driving, it will do very well indeed. Even if any one of us wants to shade the numbers from the tests. What we know is the tests at this value that if one car in city driving is supposed to get 24 miles per gallon and another car's supposed to get 20 miles per gallon, whether you believe in the 24 or the 20, I think you have good reason to believe that you will get better gasoline efficiency mileage in the 24 than in the 20 car. So we have had a strong automobile sales. Most important, I think though, is the fact that the inventory decumulation has tapered off. In fact, it may have tapered off a bit ominously because the preferred scenario would be to get rid of the excess inventories even if you don't get rid of them at the same rapid rate that manufacturing industry was getting rid of them in the second quarter. It now appears as if quite a number of people have started to accumulate inventory. Let's take retailing as an example. Last autumn, the American economy collapsed at really almost an unprecedented rate. There is no method of forecasting that I know of which correctly picked up the strength of the decline. Let me just review that fact. You will remember, from things that've been said on these tapes, that at the summit meeting, the bulk of the economists, 23 out of 28 by actual head count, were pessimistic about the outlook and thought that President Ford had a problem of recession to worry about, which was becoming as important, or they said more important, than the problem of inflation. As I recall, there was some difference of opinion on that. Dr. Beryl Sprinkel, for example, who is a respected monetarist from the Harris Trust Bank in Chicago, was, according to my notes on the meeting, the most optimistic. He thought that the economy was in quite good shape. And I think I've mentioned to you that the Federal Reserve Bank of St. Louis thought that the economy was in pretty good shape. And it seems to me that according to their theories, they had reason to be optimistic. I have before me a plot, which I have been keeping track of over the months and over the quarters and years, of what's happening to the trend of the money supply. Perhaps some of my listeners will be surprised 'cause they don't think of me as a monetarist. I will take help from any quarter. I'll take help from angels. I'll take from help from the devil if it'll help me in my forecasting. And my position has been, ever since some distant date in 1938 or '39, that not only does money matter, but money matters quite a lot. So I like to watch what's happening with the money supply. If I plot the supply of money, let's say M1, from the fourth quarter of 1969 until the second quarter of 1974, and people at the summit wouldn't have had much more than that, they would've had some readings into the third quarter because the summit in September, September 5th, was still well in the third quarter. If I plot the supply of money, not its rate of change, but the supply of money, then I find that the Federal Reserve seems to have done a remarkable job. I can put a black thread through that time series and fit it remarkably well. The trend rate of growth is at 6.58%. This connects the actual values at the beginning of the period and the end of the period. Now, the fit is not perfect. The money stock runs ahead of this trend occasionally, but it isn't very long before the Federal Reserve corrects that. And then it typically overshoots on the other side a little bit. I don't think that most monetarists who are not perfectionists would have anything to complain about if, instead of looking at the rate of growth of the money supply, and looking at the unrevised figures as they come in, that is a method calculated to make the adrenaline of any observer run at the time. If they look at this smoothed behavior and see really how smooth it is, then it does appear that the Fed must be either paying a lot of attention to the money aggregates in their own right, or they are conditioned to fear the stinging criticism of the monetarists and they therefore pay attention to the rate of growth of the aggregates. And so if I cover up the page of what happened after, say, August 1974, there is nothing in the money supply data which would warn me of anything ominous about to happen. Let's make that a little more specific. Let's plug into the Federal Reserve Bank of St. Louis's regression model, the numbers. And you don't get anything very ominous. And since there's a distributed lag, even if we think that that lag is a little bit shorter than it used to be, but of course the evidence for its being a lot shorter wasn't as strong in 1974 on September 1, on Labor Day, say, as perhaps somebody who's flexibly ready to modify his hypotheses on the basis of little sample of recent data would be inclined to do, you would get a quite cheerful outlook. And yet, we know that what ensued was the fastest decline and the longest-lasting decline in the whole post-war period. It shows that even those who make claims that having a steady rate of growth of money supply will reduce some of the variability would be ill-advised to put in their prospectus that it would wipe out all of the variability, or most of the variability. It would wipe out, it would be fair to say, a substantial amount. Well, the subsequent result was a debacle. I think it had a lot to do with what was happening to the automobile industry, and some other industry showings. There is a role in economic history for history as against for regular and repeated patterns. Indeed, the regressions of monetarism tended before this period, several years before this period, to have R-squares of about .5, .6, which means that the unexplained variance was about 40%. What we've had in recent years, and this goes back to before 1974, according to quite a number of the different variants of monetarism, which I've been monitoring, we've had more than the usual amount of unexplained variants. Well, you'd have done better if you had used a certain eclectic GNP model, in which money also matters. You'd have done better if you'd used the MIT pin, Social Science Research Council model of Professor

Modigliani. You'd have done better if you used the Wharton model, the University of Michigan model, or if you had used the Otto Eckstein data resources. But you would still not have realized the virulence of the decline, and that's, I think, because the virulence was due to business cycle factors not of the repetitive and predictable sort. Now, just to be sure that one is not misunderstood, in the subsequent period after the third quarter and during the third quarter, the rate of growth of money supply did fall off. If you look at the actual targets of the Federal Reserve, which we now have, and I commend to you a recent discussion in the Morgan Guaranty monthly letter, it seems to me an excellent discussion, also an excellent discussion of the business outlook at this time, you'll see that the Fed thought of itself as loosening. But the demand for money as a result of the weakness in the economy was outrunning the Fed's willingness to lower its interest rate targets. The money supply did fall off. Now, if you believe that money acts simultaneously, something that we've been taught by bitter experience not to believe, but you may remember there was a Laffer Ranson model that was used by George Shultz when he was the coordinator of the domestic economic scene of the Nixon Administration, and they said that the money supply in the contemporaneous quarter determines what happens to the flow of money GNP. Unless you believe that, you would not be able to explain the weakness that set in the economy in September, October, November, by the weakness of the money supply in September, October, and November. Only the weakness of this last spring could so be explained, but, of course, by the same token, what happened was that the recovery we now think came from April. Or very early in May. And again, you have to much shorten your lags. Now, you can track history and put in dummy variables of shortening and lengthening. Whatever is needed ex post in order to wipe out your residual error that you made ex ante by using past patterns of experience. But everybody knows, who has done a lot of work over a period of time in economic time series, that that way lies disaster to follow the data so flexibly is to use up all your degrees of freedom and to be saying nothing. To be saying nothing more than, for example, if I have seven points and seven constants in a six degree polynomial, I can make my sample points be fitted exactly by the fitted polynomial. But the cost of that, the price of that, is that you predict very badly once you get some new observations. Well, to return to the present situation, I've told you what the Congressional Budget Office report said, and its most interesting finding, to me. But the headlines found as the most interesting finding not simply that, that the economy couldn't be strong in the last half of 1975, but that the present policy mix unless Congress were, for example, to extend the tax cuts, would be likely in the year '76 under the announced Federal Reserve program to result in a tapering off of the strength of the recovery. That would mean we had a very short recovery from a very long decline. And by post war standards, a fairly deep decline. Now, the Congressional Budget Office did not say that the recovery would be too weak. They simply showed what the effects would be of different fiscal stimuluses, of different monetary stimuluses, they, of course, gave less emphasis to that not because they thought that the money factor was less important than the fiscal factor, but because it's not the direct mandate of Congress to set a monetary targets. A proposition which, by the way, I think that the Congressional Budget Office should rethink because the Federal Reserve is now more and more responsive to Congress. And they did another thing, which I think is extremely interesting, namely, they showed what the differential rate of inflation would be from the different policies of stimulus and of restraint. They did something very useful, in my judgment. They didn't address themselves to what the effect would be on inflation just in this next year or the year after, they also addressed themselves into what would be the effect upon the price level and the rate of inflation in 1980. Because you always can buy a little expansion in the very short run with very little cost in terms of the price level. However, it does catch up with you. And the Congressional Budget Office, in my opinion, can only benefit from leaning over backwards in being non-liberal, non-conservative, non-radical, non-reactionary. They should take into account, eclectically, any reasoned view of how fiscal stimulus, for example, will add to the rate of price inflation. And they should give more weight, really, I think, this is just my own tactical opinion, to the non-liberal side of the matter. Because I regard them as on trial with respect to at least half of the Congress. And I think that the more objective they are, the greater will be their long-run credibility. And I say this, as you know, with some interest in the liberal side. Now, there's one thing which they did not mention. And it's so important that I hope on a later tape to devote most of my time to discuss it. Namely, the fact that this will be an election year. 1976 will be an election year, and I say quite seriously and soberly that I think that any ex ante forecaster should build into his conditional probabilities that essential fact. What happens in the election year, economically, is thought to be very important as a determinant of how an incumbent fares and how rivals to the incumbent will fare at the polls. And I would like to review with you some of the evidence on that matter at greater length. Now, this does not mean that if the economy is allowed to weaken into the summer of 1976 and into the early fall, that you can then turn on the tap again unless you believe in extremely short lags between policy stimulus and effect. And I don't think that the totality of the evidence will support the weight of such a hypothesis. Then, what is to be done must be done not long after the turn of the year at the latest. In other words, we're talking about the budget period itself. And I believe that if there are signs that the economy is beginning to weaken, and particularly if the weakening in the real economy should be accompanied by some tapering off in the rate of inflation, and anyone who believes in supply and demand would, I think, want to concede that there was some such effect, well particularly under those circumstances, it seems to me that all that the Executive has to do is to change the stiffness of his vetoing of congressional expansion. As I'll develop the notion, we may once again have the case where a democratic majority in congress by its expansionism helps to re-elect a republican presidential candidate.

- If you have any comments or questions for Professor Samuelson, address them to Instructional Dynamics Incorporated, 450 East Ohio Street, Chicago, Illinois, 60611.