
- Welcome once again as MIT Professor Paul Samuelson discusses the current economic scene. This program series is produced by Instructional Dynamics Incorporated. This recording was made June 28th.

- We're now in the middle of 1973, and this is truly a branching period when even the experts are no longer so closely agreed on the probabilities with respect to the future. The preponderance of opinion still is that the American economy will go through a growth recession. Indeed, I know people who follow the business scene very closely who believe on the basis of the preliminary data available for April and May that in the second quarter itself we dropped well, well, well below the 8% real growth rate of the first quarter, that in fact the first GNP estimates will show for the second quarter less than a 4% real rate of growth. Most of those same experts don't believe the numbers because as they look at the overtime that still is taking place, as they look at the behavior of the Federal Reserve Board index of production, and as they wet their finger and hold it up in the wind, they feel that there still is strength in the economy, and they may be right, even though the first estimate of the real GNP numbers for the second quarter may be on the low side. They may be right, and the Department of Commerce may come later to revise those numbers upward. Still, I think we're being told something by the data, and you're a very rash person if every time you learn from the newly issued statistics something which is not accord with your expectation, if you substitute your own a prior judgment for the brute facts, you may find yourself very much at odds with what's going to happen in the future. We have established then I think that we are past the inflection point of the most rapid rate of growth. We don't know whether the drop, substantial as it is, is the prelude to a imminent still greater drop, but we certainly must face that possibility. Is it a good thing or is it a bad thing? Well, since I thought that the over-strength of the first quarter was a bad thing, I should feel somewhat cheered by the relaxation, and with qualifications, that is true. There is however the possibility that the slow down in the rate of growth is not due to a healthy relaxation of demand factors. Now, I don't mean by this that there has been a strong relaxation of demand, but it's gone beyond the healthy stage, and is actually turning towards malignant weakness of demand. That is a possibility, but that isn't what I have in mind at this point. I think there is the alternative hypothesis that the weakness of growth in the second quarter is because the economy is still running flat out, but it is bumping up against strong bottlenecks and barriers. And so, it's not primarily a demand factor at all, but is really a supply factor. This is not encouraging from the standpoint of controlling inflation. This is not encouraging from the standpoint of prolonging a health, healthy, prosperous expansion, because we know from past experience, and from plausible analytical reasoning, that coming up against bottlenecks of supply tend themselves to be inflationary. So, on this possibility, this hypothesis, we may be running into even more inflation ahead. More than that, and a more subtle point, is the fact that many a downturn in the past from a period of expansion to a period of recession, growth recession and absolute recession, has come about because of the economy's bumping against the ceiling of full capacity full employment output. The economy becomes geared to a sizable rate of growth. It becomes geared to it in somewhat the fashion that an addict becomes geared at an early stage to his habit, and he needs the repeated equal, perhaps high, dosages of his opiate to continue to feel so well. It's like an airplane which must be going at a certain speed, or else it'll fall. So, it's not enough for the economy to level off to a high plateau of prosperity. According to what economists call the principle of the accelerator, or the acceleration principle, which says that the rate of growth of final sales and of output is one of the important determinants of the level of capital formation, well, according to this particular principle, which goes back at least half a century, and which has had a considerable measure of empirical verification, the approach to full employment when output is no longer expansible means that like the airplane which is no longer going at the requisite rate and with the requisite angle of climb will in fact begin to turn down and to fall toward Earth. And so, there is a possibility that what we're seeing in the second quarter, and what we will see in the next two quarters of the year, is a classical case of an economy turning around, not from an overheated level to a healthfully vigorous level, temperature 98.6, or if you want to be geared for a really very successful games and battles let's make it 99, not an ominous temperature, but instead we're on our way down. On the other hand, you remember those leading indicators which in April had turned adverse. On revision, those April leading indicators turned even more adverse. But I see from the morning newspaper that the May figures have bounced back, and the leading indicator is something like six out of eight that are available at this time, have again gone towards the green light signal, and away from the orange and red light signal. It just shows of course that one month's observations are not enough upon which to base any changed view of the economy. We have to look at the broad picture. Before, however, accepting the hypothesis which I've just enunciated, that it is supply conditions primarily that explain the slow down in the second quarter, I ought to point out that there has been some relaxation of consumers' demand at the retail level. This is true at the durable goods level, and there has been some relaxation of automobile sales. And there has been some relaxation of housing. Housing starts, it's true, in May again went up, and not insignificantly. But still, the general profile of housing expenditure is on the down side. We're still living on the backlog of building permits. They are not going up. They are being used off the shelf, and we're still completing housing started at an earlier time. Now, I don't mean to suggest that the vacancy rate for single homes is ominous. It's not all that high, nor is the vacancy rate for multiple apartments, townhouses, so-called. What we used to call row houses we now euphemistically call townhouses, and we seem to want them. Well, we had better because with the cost of building so high, very many of us cannot afford single detached dwellings in the previous fashion, and we feel we get a better buy for our money, even though we have less privacy and less space, less serenity, less garden, in multiple dwellings. Well, that picture is still pretty good, but when you take into account that the flow of funds to the savings and loan associations is definitely off, off to the mutual savings banks, these are the prime sources of housing finance, then you will not be surprised to see housing go down. I think we had one month in which inventories grew faster than sales, but that was a fluke, and it was a fluke which upon examination resulted not from the fact that inventories were growing very fast. Indeed, they were growing very slowly, more slowly than is credible, more slowly than is par for the course, but in that particular month sales as reported, net grew even more slowly, and I don't think that we have come anywhere near the inventory orgasm which many of the forecasters who expect a real recession in 1974 are anticipating will happen late in the year. We haven't had that upswing in the rate of inventory accumulation to 12, 15, $20 billion per year, which will, when it happens, and after it's happened for some time, lead to an accumulation of a stock of inventories that grows relative to the sales of business, and which leads, if past experience is a guide, to a surplus of inventory on the part of business. So, they have to get rid of it, which means forced sales, which means low profits, which means cutting down on the production line, because in the last analysis the only way you can get rid of inventory is by producing less than you are selling. Well, that inventory accumulation hasn't yet happened. I've commented I think before on the fact that the official SEC Department of Commerce estimate of plant and equipment expenditure for the quarters ahead is on the more modest side, from the McGraw Hill survey. Instead of the 19% increase expected in the McGraw Hill survey I think we have something like a 13% increase reported by the SEC and the Department of Commerce. It's hard to reconcile that last writing down with the capital appropriations data which are coming into us from the conference board and from other sources, and it's been suggested to me that actually what McGraw Hill picked up in the way of empirical seismographic readings and what the Department of Commerce picked up in empirical seismographic readings are essentially the same. The only difference is that the Department of Commerce has adjusted differently the raw data which it picked up from the way McGraw Hill adjusted them. What the Department of Commerce has done, and I by the way approve of this, is that it second guessed the raw numbers on the basis of past patterns of experience. If in the past in this phase of the business cycle businessmen said they were going to accomplish more investment than three out of four times they were able to accomplish or succeeded and accomplished or did accomplish then the Department of Commerce adjusts the number saying this time too they probably will not achieve the capital formation which they say they want to achieve. So, it's a difference in adjustment that is involved, and I think we must still look upon plant and equipment expenditure as a plus. Another warning against looking at any one month's straw in the wind and forming a strong view or changing your view on that basis comes to us from the international counts. We've had lots of good news. We had an improvement in March of our balance of merchandise trade. It went from a sizable deficit to a smaller deficit. Then, glory be, in April, I think it was, we actually went into surplus in the merchandise balance of trade. This isn't the whole picture, just the merchandise. We get those numbers on a monthly basis. Well, we were all feeling very happy. We were all saying, yes, it's true. The Smithsonian depreciation of the dollar is a medicine that finally has begun to do its work, and the depreciation of the dollar in February and in March of this year, that's more of that same medicine, and by gosh, the medicine seems to be working. The balance of payments is improving the way it should. Japanese goods have become expensive. By the way, Japanese exports to the United States, our imports from them are definitely down. Go to your friendly Sony dealer, or your friendly Toyota dealer and you'll find that to be the case. So, we were kind of congratulating ourselves that although the crazy speculators in Europe who are buying gold as if it was going out of existence and who've been having a bear rate against the dollar, trying to get into marks and francs and anything else, and we've been saying, boy, they're really moving into a noose, an ambush. They're going to be sandbagged because although the dollar used to be overvalued it now is correctly valued, or maybe even undervalued, and speculation in a regime of floating currencies is a two way street, and they're putting their head in the noose and they're gonna lose it, and of course many people have said it couldn't happen to a nicer bunch of guys. Well, along came the first quarter comprehensive data from the government, and by gosh, when you went beyond the merchandise balance of payments to the basic deficit, I'm leaving out the speculative cool and hot money as it flows around. It's very hard to keep track of those volatile people, but look at the basic deficit in terms of not only our merchandise exports and imports, but our services exports and imports, our invisible items, our earnings from abroad in the form of royalties, in the form of dividends, in the form of repatriated corporate earnings, multi-national corporations and otherwise, and when you add to this the long term foreign investment which business enterprise wants to make net counting of the amount of money that comes in here as Sony begins to assemble their goods in this country, and as Volkswagen begins to think, gee, maybe we'd better get a toehold and have an assembly line in America because that may be the cheapest place to produce cars in the future, well, taking into account all of those things, there was a very comforting improvement in the balance of payments basic deficit in the first quarter. Well, just as that was happening I see the latest figures are in. I guess those are the figures for May, and the (mumbles) they have turned not only lackluster but they've turned somewhat bad, and I think that the deficit on merchandise account has worsened to the tune of somewhere between 100 and $200 million. Mean time, we still have Watergate with us every week with arrests, but during the Brezhnev visit, there are new revelations on network time TV. These revelations are known and followed on the continent, they're followed abroad, and there can't be much doubt that this political factor is one factor in the weakness of the dollar abroad. In my judgment it is a factor having to do with the buoyancy of the equity markets. How much you want to give in the way of a price earnings multiple to whatever profile of earnings you expect does depend in part upon how you feel other people with money are going to feel in terms of buoyancy. If you had been relying on the mandate of President Nixon at the 1972 election to reverse the trend of humanitarian legislation on the part of the government, reverse the trend of expenditure patterns on the part of the federal government, and if you had built that into the price earnings multiple that you felt ought to be applied to your typical General Motors, Ford, IBM, Xerox, Avon products stock, notice I've only mentioned the blue chips here. There are, what shall I say, purple chips that don't qualify for the adjective blue, which you can buy today at four and five times price earnings. Well, if you had built in that favorable political factor, favorable in your mind, into your evaluation, then it seems to me it would not be a rational view to call up your friendly broker and say let's unload some and let's sell down to the sleeping point where we're not gonna be so worried about the political events. As far as any sober econometrician's estimate of what the rate of growth of real product will be throughout the decade of the 1970s and what the general share of that national product will be that goes to wages and goes to profits, I don't think that Watergate is an important factor. If I were jotting down some regression equations, or some judgmental relations to form a judgment on this, and this by the way is what explicitly or implicitly every rational, thoughtful investor should be doing, if he's not capable of doing it for himself, then he should be having somebody invest his money and advise him who is capable of having a reasoned judgment. I don't say that he should find somebody with a glass ball that reveals the future. There doesn't exist any such person, but he should be well informed in weighing the odds, and I don't think that Watergate has any great importance in terms of such a calculation. But we know that the ups and downs of Wall Street going above the trend of so-called value and below is a much more volatile thing than that, and it does depend on what people of means, people of some affluence are thinking, and how well they're feeling with their world, and I don't suppose that too many of such people are feeling all that great in these weeks of the summer of 1973, and I think it's taken its toll. Let's ask, what about some of the objective factors that operate upon the economy? What about the money market? What about the interest rate? What about that money crunch that Albert Wolgenhauer and Henry Kaufman each in their differing degrees had forecast? I want to remind you that I spoke about Wolgenhauer's speech before the Boston Economics Club and I described to you his belief that it would be necessary and in fact was inevitable that there would be a money crunch in the middle of the year, and I wrote down in my little black book I just looked at this morning to be sure that my memory was correct that this would start some time around May 15th. This was about a month before that that the speech took place, and would develop into the 4th of July period. Well, according to my calendar we're now at June 28th. The 4th of July is just next Wednesday, and I don't think that one can hold one's breath for the money crunch having developed. Now, it's possible that all of our throats have been slit, and we haven't yet turned our heads, and we don't realize that we are the victims of a money crunch, but I don't think that the, a feel of the situation will bear that out. Now, I shouldn't be overly critical here, because nobody can be held to fine tuning and to nice picking of the exact moment of the money crunch and there was a safety valve which Dr. Wolgenhauer very properly introduced into his discussion and qualification. He said, well, if it won't be the 4th of July, then make it Labor Day, and Labor Day's a good time off, and we can by Labor Day have a much tighter money market than we now have. As a matter of fact, Dr. Otto Eckstein of Harvard University and Data Resources Incorporated has made a study of all past crunches. And we've had about three or four money crunches in the postwar period, post World War II period. I believe he traces one in 1957. I would say by the way that I think there was a little money crunch in April and May of 1953. There was a day there when all the people in the big banks and the big insurance companies were calling each other up and saying, by God, we can't let the credit of the United States government go down the drain. We can't let there be a panic in the money market. This was in the first flush of the Eisenhower first administration when you may remember Secretary of the Treasury George Humphrey was in the cabinet and W. Randolph Burgess was his under secretary, and the Burgesses which were issued really went to a great discount. Well, there are certain features in common, namely the crunches don't happen overnight. They always come as a surprise to everybody. They certainly come according to Dr. Eckstein's analysis as a surprise to the Federal Reserve, and not only are they a surprise to the Federal Reserve before the event, but after the event the Federal Reserve never admits that it had anything to do with the situation. The worst of these crunches, by the way, I think has to be thought of as 1966 in, July 1st, and we're coming right to another July 1st, there was tremendous fear that when all the savings and loan associations, particularly in California, would pay their July 1 interest that an awful lot of people were gonna take their marbles and run because by government fiat the savings banks do not let us poor people get a very high rate of interest. You can get 6% and that's the most you can get, and that's only for a very special kind of account. Well, in the regular money market you can these days get 7% and 8% if you're a man of any means at all, or if you're a corporation of any means. Well, individuals aren't so foolish that you can keep fooling them all the time, and so the smart money did in '66 leave the S and L's, really never to return. Well, the government I know, because I was an advisor to it at that time, was very fearful that there would be a big runoff, and the Under Secretary of the Treasury Joseph Barr, later to be secretary of the treasury, had a kitty, a rescue fund, or some several billions of dollars to tie the situation over. Well, we just got over that situation without undue intermediation. But there was a time in August of 1968 when the Mellon Bank in Pittsburgh finally hard pressed for reserves, said, we're just gonna dump our municipal bonds for whatever they can bring, and you had a really sticky period in the money market for a couple of days. In fact, the Federal Reserve had to act very strongly by sending a letter out to everybody that they would provide the money and not to panic. It was a good act. It was successful in ending the crunch, in turning the crunch around. I can only compare it with the forceful action by the present Chairman of the Board of Governance of the Federal Reserve System Arthur Burns at the time of the Penn Central failure. When Penn Central failed in the background there was quite a tottering of the whole house of cards. It was shaking, and even companies like Chrysler found that in the money market their commercial paper was becoming suspect. So, the president, this was President Nixon, called a lot of money people down to Washington, and Arthur Burns talked to them and said that he was gonna provide the money, and that they shouldn't panic, and actually no macroeconomic panic resulted. If this had been 1907 or 1903 or if it had been the bad old days of 1929 I think that it might have been another story. There's a book I believe by a man named Ellis on the second stock market crash. It's a hypothetical book. It's about the crash that didn't happen, but which could have happened, and it documents in great detail exactly what happened as we had a rerun, a very painful, catastrophic rerun of

1929, I guess with all the brokers jumping out the windows and all the multimillionaires saying this is a good time for my sons and I to be accumulating good common stocks. So, the sort of thing we always hear from government officials. The Secretary of the Treasury George Shultz said that if he had any money he'd be buying stocks now. He was in a good precedent, because that's what Secretary of the Treasury Dillon had said. By the way, he had some money I think at that time. It's kind of comical that a government official would know what the proper price earnings ratio is, but I believe President Nixon on several occasions has said this is a good time to buy stock, and if you had bought stock at the time he said so probably at least until recently you'd be ahead of the game. Maybe you still would be ahead of the game. Well, I don't know whether there's gonna be a money crunch. I think we have a much more sophisticated Federal Reserve board this time, and I don't think it's important for us to try to work out the odds of that. What I think is true is that the Federal Reserve has definitely been tightening up. It's been slowing down the rate of growth to the money supply over what would be needed to keep interest rates from floating upward, and interest rates have been floating upward. The short term interest rates are very high, federal funds rate above 8% much of the time. Treasury Bill rates are up. Acceptance rates are up. I think that long term rates will still be hardening. The notion that the peaking out would take place early in the year, or early in the middle of the year it seems to me is wishful thinking. Until we know more where we stand on the question of inflation, how the freeze works out and how it succeeded, and until we know more whether we're definitely in that growth recession, in that mini-recession, or even in a real recession, then I don't think you can expect the Federal Reserve to swing around and to begin to lean against the winds of stagnation and of slow growth. We still are in a period of watchful waiting.

- If you have any comments or questions for Professor Samuelson address them to Instructional Dynamics Incorporated, 166 East Superior Street, Chicago, Illinois, 60611.