- Instructional Dynamics Incorporated welcomes you to another in a continuing series of commentaries on the current economic scene. Our guest for the week of February 17th is Dr. Paul Samuelson, professor of economics at the Massachusetts Institute of Technology. Professor Samuelson, what's on the docket for this week?

- In the middle of February, the first quarter is now half over. We still have to guess what the general direction of economic activity will be throughout the year. As far as one can see from the information now available, the winds of inflation continue to blow pretty strongly. I'm just looking at the latest issue of the business cycle developments of the Department of Commerce. This has just reached my desk because of the delays and the snows. It's for January, but the February story, I think, will not be very different when it becomes available. And as I look at the leading indicators, the one series which I find most interesting, single series, is on page 34 of the January number. It shows the 12 leading indicators with a reverse trend adjustment. That has been rising for many months, is barely steady in December and January, and it looks to me like a very different picture from what that same series showed prior to the 1967 slowdown. In 1966, quite early in the year, this particular series of leading indicators began to turn down, and was turning down and moving down steadily for all of nine months during 1966. Then in the early part of the year, when quite a number of people predicted that 1967 would be a year of recession, the majority, however, said it would only be a year of slower growth, and they turned out to be right. In 1967, this series leveled off and then quite early in the year began to increase. And we know that 1967 was not a year of recession. So if I look at the leading indicators, this doesn't have the smell of it of a terribly weak first quarter or a second quarter. The bets still seem to be for some letdown in the first quarter in comparison with the fourth quarter of last year, but a lot of people are beginning to hedge those bets, and I would hate to bet on less than a $15 billion increase in the first quarter. Could well be above that. We recently received the January unemployment figures. They were again at a very, very low level. I almost said a satisfactorily low level, but in a time of inflation one can wonder whether 3.3% is a satisfactory level or whether that isn't a bit too much of a good thing. The unemployment has been at 3.3% now for two months. I would've said three months, but I noticed that the November figure has been revised retrospectively upward to 3.4%. I went to a meeting in New York where there were a great number of economic experts from the financial community. It was a small meeting, what we at a university might almost call a luncheon seminar, and there seemed to be a great division of opinion in that group. The people in the money market were impressed by the fact that the Federal Reserve had been causing a good deal of restraint in January. For the things which people in the money market themselves watch very carefully, there was quite a bit of tightness. And some of them seem to think that if the Fed had been that tight for a month, that it would now have to begin to reverse itself and go a little bit easy. My own advice was to the contrary. I don't know how strong business activity is going to be in 1969. I don't even know whether history will record that the first half of the year was the weaker half in terms of growth and the second half of the year the stronger in terms of growth, or whether the opposite qualitative pattern will emerge. But I think I can predict one thing with very considerable confidence, and I think it's a very important prediction for the people in the money market to pay attention to, and that is that the Federal Reserve is feeling displeased with itself. It's feeling guilty, and I don't think it can do penance for that guilt and work off that feeling of guilt until it has succeeded for two or three or four months in keeping the rate of growth of the money supply down significantly below recent rates of growth. My own guess would be that the Fed will cause the money supply to grow significantly less than some kind of a normal 5% rate. But in any case, one ought with some confidence to bet that they will do everything that they know how to do, to try to keep the money supply from growing at more than a 5% rate, and this for several months. So I don't see how a practical man can say that this little period of credit tightness shows signs of being over. I think it just shows signs of beginning. After we've had several months of a clear indication of slowdown in the rate of growth of the money supply, then you can begin to ask whether the Federal Reserve will nervously begin to wonder whether they've overdone it and will worry about overkill and all the things which they are so capable of worrying about. But I think it's premature to look forward yet to such concerns. Now, does this mean that the Federal Reserve has become a convert to the view that the all-important variable is the rate of growth of one or another definition of the money supply? I don't think so. I don't see any signs of this, really, in the staff of the Federal Reserve, and I don't see signs of it on the board of the Federal Reserve. But the Federal Reserve knows that there are plenty of money watchers in the community and that this is one of the things that is a concern to these watchers, and it's sensitive on that subject. It's very much like what are called technical or chartist methods in the stock markets. If you asked an experienced investment counselor or advisor, "Do you believe in the chartist methods, "in flags, pennants, head and shoulders formations, "in point and figure methods of reckoning charts?" almost to a man, they will all answer, "No, we don't believe in it at all. "It's all nonsense." Yet if you grab the Wall Street Journal from their desk and look at the next to the last page where the index of stock prices is plotted, you will see that they've drawn in the telltale pencil lines of rising and falling channels, which is part of the paraphernalia of the chartists. If you reproach them for their inconsistency, their answer is typically this. They say, "I don't believe in it, "but there are a lot of fools who do believe in it, "and therefore I've got to be very careful "and keep a close watch on the dial theory indications "and other chart manifestations." Well, so it is today in the 12 Federal Reserve banks across the nation, not in one of them but in all 12 of them and in the Federal Reserve board. There is a derivative secondary concern on the behavior of the money supply because they know that Senator Proxmire's committee is interested in that. They know that editorial writers on the New York Times and Washington Post are interested in that. They know that the First National City Bank monthly letter is interested in that. And to tell the truth, some people in the Council of Economic Advisors are quite interested in that. So I think that this will have an effect upon the Federal Reserve actual behavior. Now, what is the implication of this for various markets? I think that it has definite implications for the housing market. I've been looking over again some GNP models of quarter by quarter changes in the GNP and in the different components, and I've been particularly looking at some of the models that have produced numbers rather like my own aggregate numbers. And what strikes me in the quarterly profile there of this typical such model, is that they show dollar value spent upon housing going up and going up fairly sharply in every quarter of the year. And as a matter of fact, I've seen one set of forecasts which go right into 1970 and show a steady increase in expenditure on housing. I can't believe on the basis of present evidence that that is really in the cards. It seems to me that housing is going along at a fairly good clip now because of credit which is already committed to builders. These commitments are made some months ahead, and it's very hard to change them in the short run. This provides something of a buffer to the financial community against Federal Reserve restrictiveness and tightness. They can cut into the liquidity which they've built up just for this purpose. The conclusion, to my mind, is that that simply means the

Federal Reserve has to cut down a little tighter than would otherwise be the case. Some of you may have read in the New York Times a week or so ago an article by Edwin Dale, who's usually quite a good financial correspondent. And he said there's a big joke around Washington, New York, Podunk, Peoria, Oshkosh, and namely, everybody's laughing at the Federal Reserve. And I think that I'm part of the establishment, and I'm an insider, and that generally speaking, when there's some joking going along, I'm in on it. But I had to admit that I felt like an outlander here in Boston and in Cambridge because I hadn't heard about this particular joke. Unlike Dale's usually clear articles, this wasn't clear what the joke was. Most of the joke seemed to be that the banks were resisting the restrictive action of the Federal Reserve by drawing on the euro dollar market. Now, I don't see anything particularly surprising in that. In order for a joke to be a good joke, it has to have a twist to it. It has to have an element of surprise. What would you expect to happen when a central bank tightens up within a country? Other things being equal, you would expect that the increase in rates in that country would draw funds from abroad in some measure. This is a classical mechanism. It's not a long-run solution to a deficit in the balance of payments. But ever since the late 19th century, the time of Gossen, it's been known as an important mechanism. And so of course, one would expect it to operate now, and there's no reason to think that the Federal Reserve didn't understand that that was part of the obstacle and constraint within which they worked. The conclusion, to my mind, simply means they have to work that much harder in order to achieve any given tightness of availability of credit and any desired increase in the costliness of credit borrowing. So I can't believe with any confidence what the vast majority of the financial experts at that New York meeting did seem to believe. Our chairman asked the informal question, "How many of you expect interest rates "at the end of this year to be lower "than they are at the present time "in the first half of February?" And every hand in the room went up except mine. I was asked why I was different, and I said, "I'm different on this occasion "because in the middle of last year, "for quite a fat fee, I delivered an opinion "to one of the largest corporation in the world "that the first quarter of this year "would be a better time to borrow "than the third quarter of last year." "This was the way in which they were leaning, "but if I'd had a contrary opinion, "I would've had no hesitation "in telling them that they were all wet. "But actually, on the basis of the information "known to me at that time and my way of analyzing it, "it seemed to me that there was a fair betting chance "that interest rates would be lower "in the first quarter of this year. "Well, of course, I was wrong. "I was very wrong, and it was a chastening experience, "and not one that I'm likely to forget soon. "It has served to widen the interval "within which I'm prepared to bet "interest rates will fall three or four quarters ahead." Now, most of this group must have been thinking that by the third or fourth quarter of the year, we would actually be having a weak economy. In this connection, I'd like to call to your attention a Wall Street Journal or New York times report on this subject in which Henry Kaufman of Saloman Brothers and Sidney Homer of the same organization, two of the most astute men in the money market, were quoted in some speech or other as saying that it's the last half of the year that's going to be the weak half of the year, and the first half of 1969 which is going to be the strong half. You can see that the old majority view of the pattern opposite to that is beginning to lose adherents as the first half wears on and appears still to be strong, and they're beginning to move over to the other side. This is part of the great syndrome among economic forecasters which could be called the six month syndrome. For six months ahead, everything is going to be strong, yes. But after that six months, oh, you watch out. Things are going to turn down. If you had taken forecasts from a panel of experts quarter by quarter ever since 1946, that would have been the general bias among those forecasters, and I'm afraid that's still the case. What's the difference if there does exist such a bias among the forecasters? I think this. I think it has mattered, and I think it has distorted policy advice. It goes back to the expression that I coined in a recent tape about fine distuning. I was speaking then and disagreeing with the doctrine that a fast rate of growth of the money supply followed by an overly slow growth of the money supply is a terribly destabilizing thing and that the system is not capable of canceling off one against the other and accumulating on a longer run and a more permanent money basis the effects of such contradictory trends. And I said it's simply a case of, I exaggerate now, of paranoia and overly nervous concern to think that this is going to put the system into a tizzy. Well, I want now to generalize this diagnosis. People used to, in the pre-Keynesian days, speak as if they thought of the system as just terribly stable. Almost nothing could destabilize it. In these post-war decades, we've moved over almost to the opposite extreme, in which it's thought that the system is a fairweather system, and the slightest strains upon it are likely to plunge you into, on the one hand, deflation or, on the other hand, inflation, so that's it's flation, flation, flation all the time. I think that old view is wrong. I think the new view is wrong. I think, as Adam Smith used to say, "There's a great deal of ruin in a nation." Well, there's a great deal of momentum and stability in the march of the gross national product. And it's been wrong to think that overkill is an ever-present danger, that we're giving the patient some delicate penicillin to which he is sensitively allergic, and that exactly the right dosage is required or else we have terrible peril. The result is that people are scared of taking advance contractionary action for fear that they will overdo it. That's why the Federal Reserve was too easy, as they would now themselves agree, in the period from the middle of last year, let's say to the last month of last year. That's why these financial experts in New York with whom I was talking, all of whom agreed that we were in quite an inflationary situation, they were looking beyond it to the valley of despair that might come from overaction. And in a sense, because of this "you watch out after six months" syndrome, they were implicitly counseling the authorities not to be very activist on the contractionary side. Well, I happen to think that that's wrong, and the result of it has been an inflationary bias in the economy since the step up in the Vietnam War period.

- Professor Samuelson, one of our subscribers has a question or two for you. He writes, and I quote, "Don't you feel a need for a standard such as gold "that all countries will have a faith in? "If there are gross fluctuations in flexible exchange rates, "the peso, for example, wouldn't that signal a cautiousness "on the side of foreign investors to curtail investment, "especially in underdeveloped countries?" He goes on to say, and I am again quoting, that, "I feel if people had faith in anything, "you wouldn't need laws. "Unfortunately, there are people like me "who need laws or standards. "Therefore the need for gold as a standard. "Flexibility doesn't call for laws."

- If you're going to have a faith, I suppose it has to be a faith that is really believed in. And I don't believe that gold, in the modern age, provides such a faith. It's a fool's gold or a false gold. Nobody is going to play, in my judgment, the gold standard game. And therefore, if we pin our economy on gold and gold misbehaves, as I think it will, then you have lost all the advantages of a religious belief. I think it was Plato who said once that the art of politics is that of telling plausible lies. Well, if so, the lies must be plausible, and gold is not a faith in which man can believe. What I think one does need are a good set of rules, rules of the road. That's what good government consists of. And I would guess that the time has come for supplementing the natural shortage of gold by SDRs, by international cooperation. And I think we would do well to introduce some flexibility of adjustment toward equilibrium in exchange rates and relative exchange rates. Now, will this discourage investment in underdeveloped countries? I think that if exchange rates fluctuate and we have to pay speculators something to provide a hedge against that, that will be one of the costs of international trade in the future. It's not a cost which we've avoided in the past because periodically, we've had breakdowns followed by import quotas and so forth. But I don't know that this will be especially true with respect to the underdeveloped countries investment. And one of the tragedies of the modern world is that the real money to be made, by American corporations at least, is not, generally speaking, in the underdeveloped countries, if we leave oil aside, but rather it's in the more affluent countries like those of the common market.

- Thank you, Professor Paul Samuelson of MIT. If you have questions, comments, or suggestions, write Instructional Dynamics Incorporated, 166 East Superior Street, Chicago 60611.