- Instructional Dynamics Incorporated welcomes you to another in a continuing series of commentaries on the current economic scene. With us again for the week of January 13, is Dr. Paul Samuelson, professor of economics at the Massachusetts Institute of Technology. Here now is Professor Samuelson.

- I promised in the last tape that I would talk about interest rates. For this middle of January 1969, I don't suppose one could pick a more timely topic. Course the biggest news in the money market has been the recent increase in the prime rate. Not only has that prime rate risen to an astounding level, not seen for decades, even generations, but what is even more remarkable is the frequency with which it has moved recently. It was not so long ago that the Chase bank held the lonely position of quoting a 6% prime rate. Then the Chase rejoined the other banks. Then they all went up. Then they went up again and now we've had the latest increase. Apparently this last increase has caught Wall Street off guard. I say apparently because no one can ever be sure just why the stock market declines. There are many explanations after the fact. In deed, whenever there is a 15 point move in the Dow Jones averages, the populous presumes that there has to be some explanation for it. Perhaps there's tension in the Middle East. Perhaps the appoint of Henry Cabot Lodge, an alleged hawk, and therefore an omen that peace will be that much more unlikely. Such rationalizations are scarcely worth the paper they're written on. I only mention them to make this point. But the hardening of money, that could be a sensible and a more lasting reason for stocks to react. I don't consider it my business primarily to cast a horoscope of Wall Street, but if time permits later, I may possibly comment on some of the pros and cons of the proposition that as interest rates go up, there is downward pressure upon the index number of stock prices. What was the immediate cause of the rise in the prime rate and of interest yields generally? Undoubtedly, the immediate cause has to be traced to the decision of the Federal Reserve board to raise the discount rate. That particular decision was itself predictable from the strength that had been developing in the economy in comparison with the earlier expectations of moderation. But I should like to call your attention to something that was not done at the time that the discount rate was recently increased. At that time the Federal Reserve Board could have made a change in Regulation Q. That is, it could have lifted the interest rate ceiling that the banks can pay on timed deposits. No doubt this was discussed at the Open Market Committee meetings. And no doubt there was a tacit vote taking in the matter. But in any case for the moment, for the month, no change was made in Regulation Q. This means that market rates of interest are beginning generally to climb above the ceiling rates of interest. And we know from basic economics what is likely to happen under those conditions. If a corporation treasure can make a better yield on a 90 day Treasury bill in the open market then he can receive on a certificate of deposit, a CD, from the First National City Bank, because the First National City Bank is not permitted to bid for that deposit more than the Regulation Q ceiling rate, then in very little time, that corporation treasurer will shift some his funds or all of his funds into the open market and buy Treasury bills direct. This process of disintermediation is predictable, it is gradual, but it is quick. And so the failure to increase the Regulation Q ceiling at the time that the discount rate was increased could predictably be expected to result in runoff of certificates of deposit, a reduction in that component of the broad definition of the money supply, which CDs constitute. The Federal Reserve Board knows that better than you and I do, and so this policy was done deliberately. The thought in part must have been, let's put a squeeze on the commercial banks. Let's let the money that they depend upon start drying up so that they will begin to be more tough with their customers and this will slow down the rate of increase of ordinary commercial credit. It's like game a chess or a game of dominoes. You knock down one domino and that's knocks down another. The pressure was put upon the commercial banks. This is the reaction of the commercial banks. As one commercial banker put it very candidly, if we're going to have less money and if the market, the traffic will bear high interest rates to ration out that money, let's be sure that we make more on each dollar of the fewer dollars that the Fed is going to permit us to have. When I say fewer dollars, of course I mean a slower rate of growth in the dollars, I don't mean necessarily an absolute rollback, although there will be and has been, an absolute rollback in certificates of deposits, just as there was back in 1966 at the time of the so called money crunch. I don't think that listeners of my tapes will be astounded by all this. I have argued right along, that it is never easy to predict in economics but that certain predictions are easier than others. And if business is over-exuberant, if the inflation rate pressure continues, then that is your most important clue as to what the Federal Reserve will be doing in trying to pursue that vague policy which it calls leaning against the wind. And so the Federal Reserve has leaned a little bit harder against the winds of inflation. It has permitted the tightening of money in the money market. It has engineered a tightening of money in the money market as measured by the availability of credit at previous interest rates. There is no one way to measure properly, in my judgment the tightness and easiness of money. There's tautological way of defining it, namely by what happens to the money supply and that is what it is. It is itself. But that is only one component in a large vector of magnitudes which I monitor every month and every quarter in trying to understand what is changing in the money supply, I mean, excuse me, in the credit markets generally. Now what about the rate of change of the money supply? The latest figures that I have seen suggest that there has been an increase in the money supply, the rate of growth in November. I'm not sure what's happened in the more recent period. It's a little hard with flu and with Christmas and with the weather to be sure just what is happening to the float and to the money market magnitudes in the weeks that have just passed. But it does look as if, just as in July, there was a sudden increase in the rate of growth of the money supply, so there was an acceleration of that rate in November. Now if I gave sole weight to the behavior of the rate of growth of the money supply or if I gave almost sole weight on that vector, I suppose I should say that six months from November, that's about next May and June, the economy will be particularly strong. Actually, I think for other reasons, in the third quarter of next year, this economy is going to be particularly strong. There are going to be some special fiscal reasons, namely three billion of those reasons, the legislated increase in wage increase of the governmental employees is expected to feed in very strongly. So different explanations are going to coincide, if indeed that expected pattern does materialize. Let me say something though about the increase in the rate of growth of the money supply in November. If you take the rather simple, or simplist attitude that it's an easy thing to control the rate of growth of the money supply for the Federal Reserve, all the Federal Reserve has to do is to buckle down to it, set its mind to it. Watch one thing, number one thing like a Libertine who's primary and only interest is sex, just concentrate upon that topic number one, then the Federal Reserve has to be regarded as having departed from its senses in November. Suddenly this Board of fairly intelligent people as tested by the Darwinian process of survival in life took leave of their senses and engineered a great increase in the money supply. Now that's one way of looking at the matter. It's like a Rorschach blot test and there are a few economists who do look upon it in that way. One has no quarrel with that, although it's a bit superficial. Because those economists, if that's the only way the look up on it, have no way of predicting when these aberrations of judgment hit the Federal Reserve. So even if I held that view, I would try to dig a little bit deeper and a little bit wider in understanding the behavior of the Federal Reserve. I have an alternative hypothesis. It's not really an alternative hypothesis, but it's a supplementary hypothesis that I think my listeners might be interested in. It's a way of predicating aberrations in the rate of growth of the money supply by the Federal Reserve. It isn't terribly new with me, although I've used it for many years and it's not terribly subtle, and I don't even think it's controversial. Although if you agree with this hypothesis, it does require you rethink the interpretation of the evidence which alleges to show that the rate of growth of money is itself either the sole predictable element in terms of aggregate demand, or by all odds the most important. Now the hypothesis is the following. The Federal Reserve watches the rate of growth of the money supply. It also watches the general behavior of interest rates and the general behavior of the availability of money. It is reluctant to have interest rates become disorderly and it is reluctant to have interest rates change quote, too fast, unquote. Now this doesn't mean that the Federal Reserve is always pegging interest rates, but it does mean that it is smoothing out the fluctuations in interest rates. And if interest rates start to go in one direction, the Federal Reserve acts as something of a scalper, just the way a hedger, a speculator, or a scalper would behavior in a commodity or foreign exchange market if he sorta bet on the law of averages and against any one new event as being of cataclysmic importance. And generally speaking, as far as the price in that commodity is concerned or the foreign exchange market is concerned, unless he's wildly wrong in this presumption he performs a stabilizing function for that price. I should add that stabilizing price often destabilizes a quantity. And as the Fed modulates the changes in interest rates it thereby accentuates the fluctuations in the rate of growth of the money supply. Well that's of course my point. I've had some limited success in predicting excessive fluctuations in the rate of growth of the money supply around it's mean, from residuals in the rate of growth of the economy itself. When the economy grows faster than people had expected or than they liked, and when I say people, I mean authorities, then I've noticed there is a concomitant tendency for the rate of growth of the money supply to increase. Since strength in the GNP in any quarter tends to be positively correlated with strength in the GNP in the next quarter and the next quarter after that, there is a spurious correlation that some people fall prey to, in which they think that all of that subsequent strength is due to the money supply. Actually, it is very easy to construct on a computer or even with pencil and paper, a model, in which by hypothesis money has no causal influence. That by the way does not happen to be my position. My position is that, the behavior of money is a very important thing. The behavior of government expenditure is a very important thing for effecting the predictable level of total effective demand. The behavior of tax rates and taxation is a very important thing for effecting the total. I wouldn't like to give quantitative precision to that and say since I've named three factors, each one has a 33 1/3% importance. It's much more complicated to state the relative orders of importance. But let me go back now, because I think it will help us understand the money market as it develops in the months ahead to an artificial model, which is very easy to construct, in which money is the tail of the dog and the behavior of the fiscal and other variables of gross national product are the body of the dog and this wags the money tail. Now if we take such an extreme model, in which today, in this country, as far as I know, nobody believes. I think you could have found in 1939 a number of people, maybe even a majority of the people who believed in a model something like that. By 1949, their number had thinned down. And I supposed there's some people, who whatever they learned at the age of 25 never changed their mind thereafter. And so there must be a generation of people born in 1914 who are economists today and who believed what I'm describing in 1939 and still believe it and will go down to their graves believing it. But I can't honestly identify any in the

American scene. There are more, I might mention, in London and in England and some of us are engaged right at this time in trying to reeducate the English on the importance of money, the fact that money does matter. It's only right that we should reeducate the English, because the English have done so much to educate us Americans over the centuries. This is a return, lend-lease. It's hard work to reeducate English economists I may say parenthetically, but there does seem to be a little bit of progress. Well in that model, in which nobody believes, you get timing pretty much like that, which we actually see in the marketplace today. That's what makes it so difficult to infer from contemporary experience, exactly what true model lies behind. And yet, that's the art of economics. That's the art of the science of economics. That's the essence of economic judgment. How to piece together all the little bits of evidence, some of which are contradictory, some of which are overlapping, some of which are irrelevant into the most plausible hypothesis for the understanding, explanation, and prediction of future events. Well in this laboratory model, we pick up a very strong influence for money even though we put into the model no influence of money, because of the fact that when the body of the dog is very strong, it gives the tail of the dog a very strong wag. And when the body of the dog is very strong, for reasons of continuity and the serial correlation, it tends to be strong in the following period. A very naive empirical scientist who sees the tail of the dog give a strong wag, says ah ha, that was followed by strength in the body of the dog and therefore the tail, I state the new proposition, the tails of dogs are what wag dogs. Well I am of course caricaturing the subject, but I think I do a certain rough justice to some of the work which passes my desk in so doing. No I don't wanna be dogmatic on this, it's a very complicated problem, and I think some wise man has warned us against the use of analogies. And often when analogies come in, of then the case is very weak, and we ought to listen to all the wise men. It's not a question of dog and tail, it's more the question of moon, earth, sun, mutual determination between, this is my opinion between fiscal variables, between the spontaneous behavior of private capital formation and the Federal Reserve created change in the rate of growth of the money supply. Now let me turn back to the immediate money market. Where is this all going to go? Again, I remind you, the single most important factor in understanding where an April's Fool Day interest rates will be, is to form some judgment as to what will be the strength of the GNP, what will be the strength of department store sales, all the main components between now and April 1. Because when the Open Market Committee meets on April 1, what will be freshest in their mind will be what the economy has been doing in the last two or three months. And their staff will have prepared for them a set of extrapolations based upon a longer period than that, but the tone of those extrapolations will very much be determined by the strength of the economy. So that leads me to the perennial question which we'll come back to week after week, because it is topic number one for anyone who is following the contemporary behavior of an economy like the American economy. What is the outlook for GNP in general? Now you know the view that I prepared for New Year's, because I mentioned it here. It was for a 924 billion GNP. At the time that I prepared it, I was rather ahead of the crowd. The National Industrial Conference Board figure associated with the name of Paul McCracken, although he was only one member of that panel at that time and at that time had not been designated as Chairman of the Council of Economic Advisors was for 915 billion. There is a panel at the National Bureau of Economic Research is now interrogating at regular intervals to see how well such a panel of economists does in prediction and I could predict what their prediction would be and it was. It was in those same levels. One of the things about such panels as I've noticed, and I use it to predict their behavior and predict the errors in their behavior, is that they're always behind. They're always behind the most informed judgment of the frontiersman and that's why the government hands down has won in its predictions with the Business

Advisory Council for the eight years. I've been making a tally of what the Business Advisory Council people, with some of the best business economists in the business there and what the contemporaneous government predictions are. And heaven knows the government predictions have not been anywhere near perfect. It's hard to say whether they've been excellent or good or fair, but they've been a lot a better than those of the Business Advisory Council. But for precisely for this reason that the Business Advisory Council is giving the conventional wisdom of six weeks earlier. Since New Year's we've had time passing and I would say that most of the predictions that I've seen are coming up to my own level and even going beyond. The last that I should add to the sweepstakes is that of Walter Heller. Walter Heller writes an occasional letter for the National City Bank of Minneapolis. I imagine that any interested person can get on their mailing list for this. I always read it with great interest. I'm a friend of Walter Heller's and you must discount what I'm saying on that account. I have an even greater interest because as he said in the latest issue in a footnote, the quantitative forecasts in this letter are largely the work of my colleague at the University of Minnesota, Professor George L. Perry. Well Professor George Perry is an old friend of mine and is a PhD from MIT. So over the years I've watched his work and developed a certain amount of confidence in his numerical predictions. Walter Heller predicts even more than I do, 926 billion, this is as of January 7 prediction. And my impression is that inside the government itself, the predictions are getting to be around the 925 level. I won't go into the reasons for them, but I will conclude by speculating something that you will know the answer to, perhaps by the time you listen to this tape. What will the outgoing President Johnson recommend with respect to the surcharge when it expires on July 1? Now we've heard a lotta gossip about that. I hope that if he says anything at all, and just doesn't say reserve judgment and say it's for the new man to decide, that he will say nothing, which suggests that the surtax ought definitely to be repealed. I don't think we can prudently dispense with the surtax based upon my present pattern of information. He could say, cut it by 5%. Now there are some political considerations of jockeying. So if the economy were to turn weak and Mr. Nixon were to find it advantageous to repeal the tax in July in entirety, Johnson might feel he'd been outmaneuvered if hadn't already recommended it. But I hope will throw all political jockeying to the winds as he goes out and call the shots exactly as he sees them at this time. Now how should he then call the shots? If he were to ask me for a judgment in this matter, based upon everything that I know including the kind of prediction that I have made for the year, it seems to me that it would be imprudent at this time to talk of repealing the tax or cutting it down to 5%. Well we'll see what the President, the outgoing President does say. Thank you.

- Thank you professor Paul Samuelson of MIT. If you have questions, comments, or suggestions, please feel free to write us at Instructional Dynamics Incorporated, 166 East Superior Street, Chicago 60611.