

# STABILIZATION ACTIONS IN 1969— HOW MUCH RESTRAINT?

**T**OTAL SPENDING has continued to rise rapidly in 1969 and price increases have accelerated. Monetary and fiscal restraints have been maintained, however, and subject to the lags between policy actions and the response of economic activity, total spending can be expected to show definite indications of slowing later this year. Following a deficit of \$25 billion in fiscal 1968, the Federal budget was slightly in surplus in the fiscal year ended in June, and a larger surplus is expected for the current year. The monetary base, bank reserves, and money grew much more slowly in the first half of this year and have shown little or no growth in recent months, after expanding rapidly in 1967 and 1968.

In addition to the lag between stabilization actions and their impact on total demand, there is a further lag before prices respond. Inflationary expectations, apparently entrenched in economic decision-making processes, may have dampened the initial impact of monetary and fiscal restraints on economic activity.

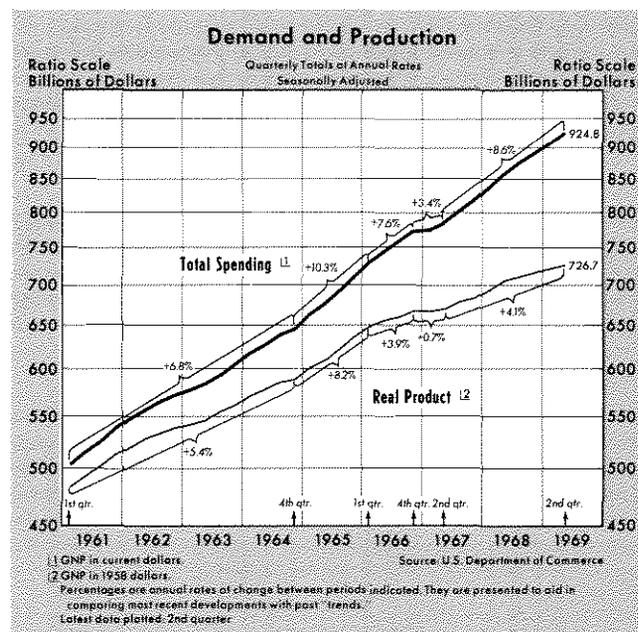
## *Demand, Production and Prices*

Total spending has increased at a 7.7 per cent annual rate since mid-1968, only slightly slower than the 8.6 per cent rate of increase from early 1967 to mid-1968. Growth of spending in 1969 has included a rapid expansion of business investment in plant and equipment, which rose at a 13.5 per cent annual rate in the first half of this year, compared with a 5.1 per cent increase in the previous year. The increase in business investment more than offset declines in resi-

dential construction. Housing starts fell from an average annual rate of 1.6 million starts early in the year to a 1.3 million rate in August. During the period of monetary restraint in 1966, housing starts averaged a low rate of 1.2 million.

Consumer spending has continued strong, showing little response to the tax surcharge imposed in mid-1968. Consumption expenditures rose 8 per cent in the year ending in the second quarter, about the same as in the previous year.

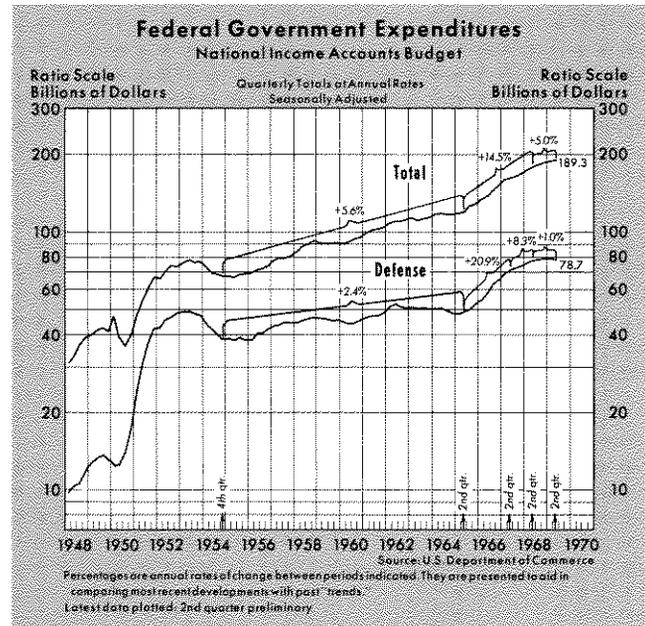
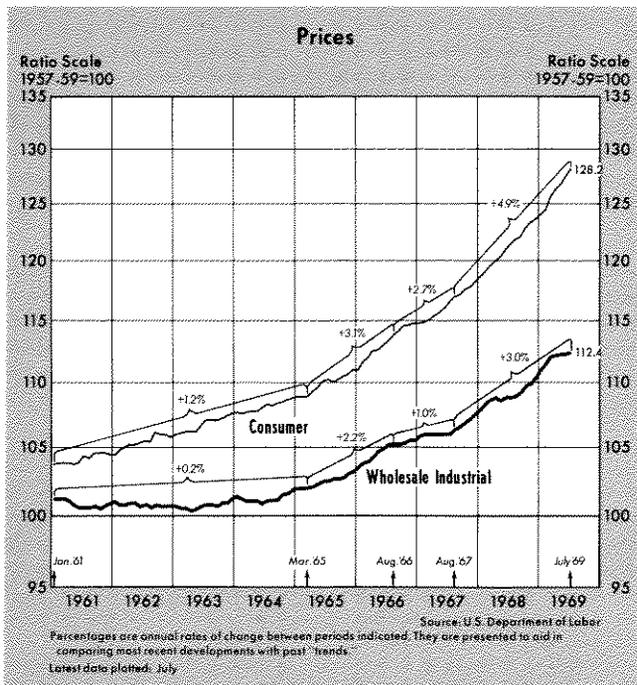
While total spending continues to rise rapidly, growth of output has slowed. Real product growth



has moderated since mid-1968, slowing to a 2.3 per cent rate in the first half of 1969, compared with a 3.6 per cent rate in the second half of 1968 and a 4.7 per cent rate from early 1967 to mid-1968. The rapid growth in real product until mid-1968 was unsustainable, since it exceeded the rate of increase in productive capacity. Expansion of output in the past year, when the economy was relatively fully employed, has been accompanied by declining productivity. This decline is evident from the slowdown in the growth of real product relative to employment. Most of the decline in productivity has apparently been centered in the output of services, as manufacturing output per man hour has changed only slightly.

Growth of total real product has slowed, but industrial production has increased at a rather steady 6 per cent annual rate from August 1968 to August 1969. Industrial production increased at a 4.9 per cent rate from mid-1967 to August 1968.

Price increases continue rapid in response to excessive total demand. The general level of prices increased at a 1.4 per cent annual rate in the 1960-65 period, at a 3 per cent rate from 1965 to 1967, and then at a 4 per cent rate through 1968. During the first two quarters of this year, overall prices increased at a 5.1 per cent rate, and preliminary data indicate that the trend continued in July and August. Consumer prices have risen at a 7 per cent annual rate in the last six months, compared with a 5 per cent increase in the previous year.



*Measures of Fiscal Actions*

The Federal budget deficit, on a national income accounts basis, was at a \$9.5 billion annual rate prior to enactment of the income tax surcharge and curbs on Federal spending in June 1968, then declined sharply in late 1968. The budget attained balance by the fourth quarter and a surplus rate of \$12.5 billion in the second quarter of this year. The magnitude and speed of the shift in budget position suggests a substantial dose of fiscal restraint in the past year.

The information provided by the national income accounts measure of the Federal budget is incomplete and misleading, however, because it fails to take proper account of the effects of cash deficits and surpluses on private borrowing. If the Government attempts to finance a budget deficit by borrowing from the private sector, and the stock of money is unchanged, funds are bid away from private use. Thus, while Government spending in excess of taxes tends to increase total demand, borrowing from the private sector to finance a budget deficit tends to depress private demand. Deficits accompanied by monetary expansion, however, are stimulative since there is little, if any, offsetting effect on private spending. It is in this sense that conventional budget measures may provide a misleading indication of the impact of fiscal actions on total spending; the method of financing a deficit determines the degree of expansiveness of a given fiscal program.<sup>1</sup>

<sup>1</sup>Such criticism also applies to the high-employment budget, which during times of significant unemployment is even further removed from the financing needs of the Government.

If private demands for both goods and credit are weak and resources are not being fully utilized, a deficit is usually appropriate because of its tendency to promote monetary expansion.<sup>2</sup> But budget deficits are not necessary for monetary expansion. Monetary authorities possess the means to conduct monetary actions independently of the Federal budget position.

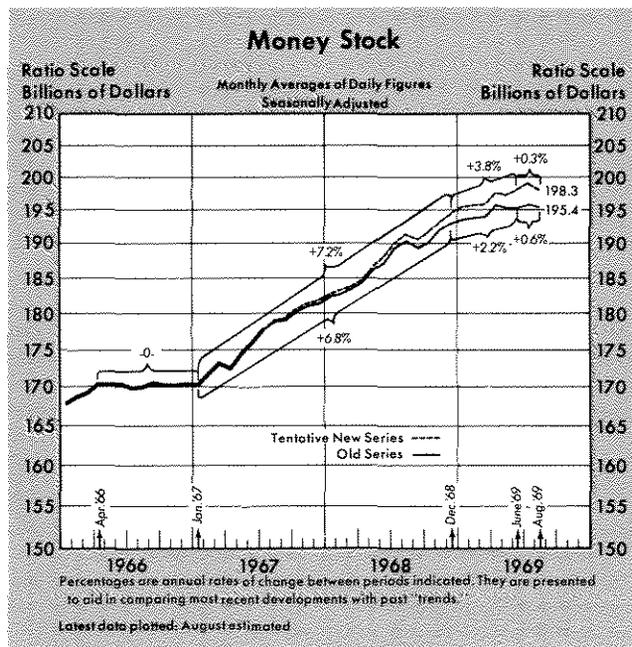
*Measures of Monetary Actions*

The influence of monetary actions on economic activity may be best indicated by movements in the stock of money. If the increase in the stock of money exceeds the growth of demand for money to hold by economic units, those units which have more money than they want to hold will try to reduce their cash balances by spending either for goods and services or for financial assets. The process of spending provides other units with excess balances and the process is repeated. The net result is an increase in aggregate income, and adjustments in interest rates and the value of other assets sufficient to equate the actual stock of money in the economy and the desired stock. In this manner, increases in money at a rate greater than the growth of the demand for money to hold tend to stimulate total spending for goods and services and for financial assets. Conversely, insufficient growth of the stock of money relative to demand leads to an attempt to accumulate cash balances from current income and acts as a brake on total spending.

Monetary actions continued to be stimulative in the last half of 1968, as fiscal policy became restrictive. The money stock, which had grown at a 7.2 per

cent rate in the first half of 1968, rose at a 6.9 per cent rate in the second half.

Since December monetary actions have been directed toward restraining total spending and inflation, and these actions have been facilitated by movement of the Federal budget into surplus. The money stock increased at a 3.6 per cent annual rate from December to May and at a 2 per cent rate from May to August. In comparison, money grew at a 7 per cent rate in the previous two years.<sup>3</sup>



The reduced growth of money reflects the moderated growth of Federal Reserve credit, monetary base and bank reserves since December, as shown in the accompanying table. The base has declined at a 1 per cent annual rate since May, after rising at a 5.3 per cent rate in the first five months and following a 6.5 per cent rate of expansion during the 1967-1968 period.

Most interest rates declined during July, and leveled or rose during August and early September. This little change, on balance, probably reflects some weakening in the demand for funds. Business loans at large commercial banks have changed little since May, after increasing at a 16 per cent rate earlier in the year. The fact that interest rates have risen more slowly recently may be a re-

	Dec. 67 to Dec. 68	Dec. 68 to May 69	May to Aug. 1969 p
Total Reserves*	7.8	2.4	-11.6
Federal Reserve Credit	10.2	5.6	0.9
Monetary Base	6.5	5.3	-1.0
Money Stock*	7.0	3.6	2.0
Demand Deposits*	6.9	2.9	0.5
Currency	7.4	6.8	6.4

Note: The money and demand deposit series are tentative, subject to further revision in the near future.  
p — Preliminary  
\*Revised series.

<sup>3</sup>These figures are based on a revised money stock series, adjusted for the effect of Eurodollar transactions on the demand deposit component of money. Omission of this adjustment led to an understatement of actual money growth. The exact adjustment and its effect on the money stock series is explained on page 3 of this Review.

<sup>2</sup>See Michael Keran and Christopher Babb, "An Explanation of Federal Reserve Actions (1933-1968)", this Review, July 1969.



flection of some moderation of economic activity and of credit demand, and is not an indication of easing of monetary restraint.

### *Response to Stabilization Actions*

Growth of real product has slowed since passage of the tax bill, reflecting primarily constraints on the ability of the economy to expand production of goods and services at a high level of resource utilization. The earlier rapid rise in total output forced employment of less efficient resources, and growth of productivity, especially in service industries, could not be maintained.

The prospects for continued long-term economic expansion are reflected in business plant and equipment spending plans. Business investment projects are ventures undertaken to yield a flow of income over the future, and, consequently, businesses must forecast demand for long periods into the future in order to estimate the revenue which can be expected from investment projects. Plans for rapid plant and equipment expansion therefore serve as an indication that businesses expect continued sales growth.

Late in 1968, businessmen expressed plans to increase plant and equipment spending by 14 per cent in 1969, despite the restrictive nature of fiscal policy. This represented a substantial increase from the 5 per cent rise in such spending in 1968. Investment in plant and equipment increased at about a 13.5 per cent rate during the first two quarters of this year, but recent surveys of business investment plans indicate some slowing in the second half of the year.

Currently businesses plan to spend 10.5 per cent more for plant and equipment in 1969 than they spent in 1968, which suggests a 5.5 per cent increase in spending during the second half of 1969.

Fear of continuing inflation has apparently caused some individuals and firms to buy goods to avoid expected further price rises. In the last half of 1968 fiscal policy succeeded in slowing the growth of take-home pay by increasing taxes, but economic units compensated by spending a larger portion of their income. The net result was little slowdown in spending.

The impact of monetary restraint in 1969 may have been cushioned somewhat by inflationary expectations. The alternative cost of holding cash has increased as interest rates have risen, giving incentive to economize on cash balances. Expectation of inflation puts upward pressure on interest rates. Users of funds are willing to pay higher rates as they expect to repay their indebtedness with depreciated dollars. Limitation of growth of demand for cash balances resulting from anticipation of inflation offsets some of the restrictive impact of reduced growth of the money stock.

As economic activity slows, the demand for funds usually weakens and, given the supply of funds, interest rates tend downward. The cost of cash balances thus decreases and the quantity of money demanded increases. If monetary expansion continues to be relatively moderate, the restrictive influence of such monetary action would then be intensified.

Forecasts based on relationships presented in the November 1968 issue of this *Review* indicate that growth in the money supply at the 3 per cent rate prevailing since December would lead to a slowing in total spending to a 6 per cent annual rate by the fourth quarter. Past experience suggests, however, that such a slowdown will not be manifested in a moderation of price advance until well into 1970.

### *Conclusion*

Total demand is strong and prices continue to increase rapidly. The prospects are for slowing of economic activity later this year, but little weakness is yet evident in the growth of total spending, employment and production. Monetary restraint has been operative since December, and fiscal restraint since mid-1968, and their effects will probably be progressively manifested in the trend of total spending as time passes.