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MEETINGS

August 3, 1970

Dear Bill:

It was good to see you again last month. Our conversation was all too brief and I do want to apologize for a schedule that developed sudden complications that day.

Thanks for sending along the interesting notes.

Regards,

Paul W. McCracken

Mr. William H. Chartener
Vice President-Economist
Goldman, Sachs & Co.
55 Broad Street
New York, New York 10004

27 JUL 1970

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William H. Chartener
VICE PRESIDENT-ECONOMIST
212-676-7542

July 21, 1970

Honorable Paul McCracken
Executive Office Building
17th & Pennsylvania Ave.
Washington, D. C. 20551

Dear Paul:

Enclosed is a copy of a memorandum that I have distributed to my associates summarizing discussions I had in Washington last Thursday. I hope you will find it of interest.

Sincerely,

Bill

WHC:ib

GOLDMAN, SACHS & CO.

SJ
PM

July 20, 1970

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WASHINGTON NOTES

These notes reflect confidential discussions in Washington last week with several leading economic officials in the Administration and Congress. For convenience, they are arranged according to general subject.

General Economic Conditions

The second quarter figures released Thursday indicate, at first glance, a small increase in economic activity and an appreciable gain in reducing inflation. Real GNP was reported to be up slightly, and the implicit price deflator for the second quarter was reported as 4 1/4 percent, down from 6 1/2 percent in the first quarter. Both press treatment of the figures and the stock market reaction appear to exaggerate the significance of these modest indications that the state of the economy is improving.

(1) The estimated rise of $10.6 billion in current dollar GNP is larger than the increases of $7.8 billion in the first quarter of 1970 and $9.1 billion in the fourth quarter of 1969. But this was the result of a change in the direction of inventory investment, which had decreased in the preceding two quarters but is now estimated to have risen $1 billion in the spring quarter. Final sales rose only $9 1/2 billion, after increases of $13 billion in the last two quarters.

(2) The estimated increase of $0.5 billion in real GNP, after a combined drop of $7 billion in the preceding two quarters, does suggest a stabilizing of output activity -- but nothing more. These initial estimates are always a bit shaky, as they are based on only two months' data on inventories and foreign trade. Revised data could show either a slightly larger gain or a small minus.

(3) The apparent improvement of over two percent in the implicit price deflator includes one percent that reflects the impact of the federal pay increase. (Even though effective in the second quarter, the retroactive payment and all the price effect were fed back into the first quarter figures.) Much of the remaining drop was due to the technical nature of the index -- which is based on shifting weights -- rather than any real improvement in price performance. The small tangible gain of a few tenths of a percent came from the fact that wholesale prices have been rising more slowly in the past few months.

The annual revisions of GNP figures for the preceding three years were surprising in that they resulted in a reduction of last year's estimate by almost $1 billion rather than the usual marking up of around $5 billion. The most striking changes, based on revision of 1969 figures, were:

(1) A marking up of consumer nondurable expenditures by $2 billion, indicating that the retail trade figures published by the Census Bureau have had a downward bias.

(2) A marking down of state and local government expenditures by $2 billion, mostly in construction, indicating that state-local spending has been constricted by tight credit more than had been thought.

(3) A marking down of corporate profits before taxes by $2 1/2 billion and after-tax profits by $2 billion, based on the availability of IRS data for 1968.

The new figures for the second quarter and the GNP revisions point to the following as key features of the economic outlook for the next two or three quarters:

- Consumer income and consumer spending stand out as the main prop to the economy and the only likely source of significant gains in demand for output.

- Housing construction should share in the growth in consumer spending and also will be aided by governmental promotion efforts and whatever easing takes place in credit.

- Business capital spending and planned inventory building will be held down by the attitude of caution engendered by recent sales and profit disappointment.

- Government spending at all levels will be held down by defense cutbacks, efforts at fiscal restraint, and municipal finance problems.

- Unemployment is likely to rise above the May peak of 5.0 percent because of the sluggishness of economic activity and the caution employers will exercise in new hiring. Some government officials now talk of a 5 1/2 percent unemployment rate in the second half of 1970 and early 1971.

- Inflation seems likely to diminish, though the degree is in doubt. Some forecasts within government project a decline to less than 3 percent in the rate of increase of the GNP price deflator by early 1971.

Federal Budget

The budget outlook for the current 1971 fiscal year is disturbing, and for 1972 it is alarming. Current estimates for the fiscal year that ended June 30 are that the deficit ran $3 billion instead of the May estimate of $1.8 billion. Guesses on fiscal 1971 now run in the $8-$10 billion range, while early guesses on fiscal 1972 are in a $13-$20 billion range.

Revenue estimates, especially from corporate income taxes, have run too high, probably by about $3 billion for fiscal 1971. Tax proposals are likely to yield far less than estimated; the proposed tax on leaded gas is going nowhere. And expenditure overruns are expected from both uncontrollable expenditures and from Congressional generosity. Also, in fiscal 1972 the working out of the 1969 tax reform act begins to cut heavily into tax receipts.

Administration officials evidently have been instructed to stop dropping hints about new tax proposals in January, as Secretary Kennedy and former Budget Director Mayo had done a few weeks ago. The Congressional mood is now hostile toward any tax increases, except perhaps devices like the proposed speed-up of estate tax collections. And there is probably some significance in the disposition of economists to turn the discussion from the unified budget to the "full employment budget," suggesting that a substantial budget deficit might not be inappropriate in a period of underemployment of labor and other resources.

Depending on the outcome of the fall Congressional Elections and the shape of budget estimates next winter, however, I am still inclined to look for some new tax proposals in January. One possibility would be to postpone the institution of further increases in the personal tax exemption. Some Administration officials have indicated support for a value-added tax; but Chairman Mills of the Ways and Means Committee has repeatedly stated his opposition, which would be decisive.

Incomes Policy

A difference of opinion remains among Administration officials regarding resort to "incomes policy" or some other modified wage-price control program. Public discussion of the issue has been quieted. The Productivity Commission is clearly an effort to satisfy some of the demands from Congress and pressure from certain Administration officials to do "something" beyond general fiscal and monetary restraint.

Some critics note with amusement the fast turnabout of the Administration in first opposing Senator Javits' proposal of an "inflation alert" and then shortly afterward incorporating this concept in the charter of the new Productivity Commission.

One sophisticated reason offered for opposing an incomes policy is that it would likely have its greatest impact on profits. It might be slightly effective in moderating inflationary wage increases but would certainly be more effective if turned against price increases. The squeeze would be bound to be felt in further shrinkage of profit margins.

Foreign Trade

Adminstration officials are concerned about the strength of protectionist sentiment in Congress, and the trade bill now before the Ways and Means Committee threatens to get out of control by the time it moves through the Senate. Both Commerce Secretary Stans and Chairman Mills had hoped to use the threat of legislated quotas on textile products as a lever to induce Japan and other producing countries to restrain their exports to the U. S. and relax some of their own import barriers.

Thus far, they have failed in this objective. Now other industries, some with more persuasive economic cases for protection than textiles, are seeking seats on the bandwagon.

The result may be a bill that the President will feel compelled to veto, as retaliation by European nations could inflict heavy damage on some of our export industries. It is conceivable that this Congress would override a veto. If not, then the result might be no trade legislation at all.

Two specific points of interest:

- The action by the House Ways and Means Committee rejecting Administration pleas for repeal of the American Selling Price formula for levying duties on certain chemicals reflects Congressional sentiment that this provision should be used again in future trade negotiations. In the Kennedy Round the repeal of the ASP was promised by U. S. negotiators in return for reduction of certain tariff rates. The Congressional feeling is that it should not have been used for that purpose but rather as an exchange for reduction of non-tariff barriers. There also seems to be lingering resentment that the U. S. negotiators in the Kennedy Round offered up the ASP without proper advance consultation with the chemical industry and with Congress.

- The provision on oil import quotas inserted by the Ways and Means Committee does not represent new policy but does serve to cement previous Administration policy into law. As in the case of the tax reform bill last year, this result may be due in part to the Administration's own indecision in formulating and pushing a policy of its own. There are times when Congress, particularly when controlled by the opposition party, cannot resist the invitation to move into a vacuum.

William H. Chartener