

WHERE DO WE GO FROM HERE?

by Allan H. Meltzer

A declining dollar, a falling stock market, and rising long-term interest rates describe the reaction by financial markets, at home and abroad, to the administration's actions. Currently we do not have an economic policy to reduce inflation, balance the budget, encourage investment growth and high employment.

The financial markets see that there is no policy. The stock market, the bond market and the foreign exchange market shout their disbelief at the administration's statements about increasing investment, reducing inflation, balancing the budget, or supporting the dollar. They sense that the lack of policy, the drift to controls, and the reliance on stop gaps will continue.

The Dollar Problem

Each time that Secretary Blumenthal goes abroad, the value of the dollar plunges. The reason is not hard to find. Secretary Blumenthal urges the Germans, the Japanese and others to do as we do. His advice is rejected. Market participants find their worst fears about the United States confirmed. They see, or believe, that the U.S. intends to continue on its present course while Germany, Switzerland, Japan and others continue on their courses.

Secretary Blumenthal cannot "talk the dollar down" any more than his predecessors in the 1960's were able to "talk the dollar up." The Secretary's statements and the responses by his counterparts abroad, however, assure market participants that their worst fears about U.S. policy are correct or possibly understated, so they sell dollar bonds and stocks, sell the

dollars for foreign exchange and invest abroad. By rejecting the Secretary's advice, foreign governments announce that they do not intend to inflate as much as the United States, so the dollars that investors sell flow to those countries that pursue less inflationary policies.

There is no mystery about the flight from the dollar, the decline in the stock market or the rise in rates of interest on long-term securities. Nor is there any mystery about the rise in the value of marks, yen, and Swiss francs. They are all, in large measure, a response to the differences in anticipated rates of inflation in the United States and other countries.

Comparisons of price levels or rates of money growth in the United States and in Germany or Switzerland do not show why investors are shifting from dollars to D-marks. Price levels and rates of money growth are history. The rate of inflation to which investors respond is the anticipated future rate of inflation.

The investors may be wrong. Secretary Blumenthal and his colleagues in the administration may prove to be right. The entire problem may be, as they say repeatedly, that we have expanded output more than others, so that the dollar floats down because we have a trade deficit, that as the others expand, the trade deficit will shrink, the dollar will strengthen and the problem will be over. But the financial markets do not believe that this is the whole truth, however correct it may be in part. They sell dollars for many reasons, but mainly because they believe the United States has no policy to increase investment and reduce inflation.

Energy and the Dollar

President Carter seems convinced that the problem with the dollar is that we import too much oil. He argues that, once the Congress passes

his energy program, the dollar will recover some of its value because oil imports will fall. Although this explanation is popular it is wrong in emphasizing oil imports as the main explanation of the dollar's decline. Germany, Switzerland and Japan import a much larger proportion of the oil and gas they use than we do. Yet their currencies rise as ours falls.

Energy legislation and the dollar are not unrelated. By raising taxes on energy, the administration's energy program reduces the budget deficit and therefore reduces the amount of securities that the Treasury must sell. A lower deficit puts less pressure on the Federal Reserve to print money to finance the deficit, so the anticipated future rate of inflation in the United States will fall. But the tax on energy does nothing to increase the future supply of energy. It is a tax on the efficient use of resources and, therefore, on growth.

The Carter energy program and the response to the program by the Congress cannot be a source of confidence to investors. The government insisted on making the energy problem an energy crisis by building a large bureaucracy, by transferring decisions from markets to administrators, and by refusing to allow prices to allocate current energy supplies efficiently and to increase future supply.

The way in which energy policy has been discussed, the type of legislation proposed, and particularly the failure by Congress and the administration to remove controls on prices is a message to investors at home and abroad that is far more powerful in its implications than the statistics showing a deficit in the current balance of trade. There is no confidence in the U.S. policy because there is no policy for dealing with long-term problems.

There are, instead, expedients and stopgaps designed with much more concern about the distribution of income than the production of income.

Our failure to respond rationally to the higher price of oil tells investors in dollars and in dollar assets, both Americans and foreigners, a great deal about the drift toward political control of markets. The Carter administration did not create the energy problem. They inherited the problem, but they failed to solve it or to offer a rational program leading to an eventual solution.

Investment and Crowding Out

The key to future growth is higher spending on investment in durable capital. Everyone agrees on that.

The administration has proposed a tax cut for business and consumers to stimulate investment by increasing consumer spending and by raising after tax rates of return. These proposals are in the right direction, but they are too small to offset fully the effects of tax increases for social security and proposed taxes on energy. And these are not the only, or even the most important problems faced by those who make investments.

The current and prospective future deficits are major obstacles. The deficits must be financed either by higher taxes, by inflation or both. Businessmen looking into the future cannot fail to see that the Carter administration does not have a policy that will produce a balanced budget, lower tax rates and less inflation.

A few years ago, crowding out was widely discussed. Some argued that part of the saving used to finance large budget deficits would have financed private capital spending. Real rates of interest on long-term bonds would have been lower and real investment higher if the deficit had

been smaller. Perhaps there would have been a little less stimulus then, but more capital, higher productivity and more income now and later.

Others, convinced that crowding out cannot be a problem with unemployment at 7% or 8% argued differently. Large deficits stimulate the economy, produce more income and therefore more saving. The addition to saving finances the deficit. Crowding out can only be a problem at, or near, full employment.

Now, looking back, we can see the outcome more clearly. Although the economy recovered from the 1974 recession at a rate about equal to the average for postwar recoveries, investment has lagged. Total fixed investment in 1972 dollars remains at the level of 1972 and well below the peak reached in 1973. Production of business equipment has risen more slowly than the index of production. New orders for non-defense capital goods, adjusted for inflation, remain well below their previous peak. Contracts for construction of commercial and industrial buildings, in real terms, reached the 1966 level only recently and remain 25% below the peak reached in 1973.

None of the measures of capital spending adjust for the higher proportion of investment in safety and pollution control equipment. If adjustment is made, the rate of growth of capital looks even more puny, and the loss of future real income looks even more startling.

Financial markets repeat the story told by real investment. Spreads between short- and long-term rates of interest remained high during most of the recovery and have widened recently.

None of the evidence shows that deficit spending had no effect on output and employment. But there is now reason for those who denied the

possibility of crowding out to re-examine their arguments. Investment has lagged behind and shows no sign of spurting ahead. Employment has increased but inflation is rising.

The capital markets sense what the government cannot admit. We have no policy to increase long-term investment, lower inflation, reduce unemployment, and lower the real tax burden. We have a series of stopgaps, a drift toward controls, regulation, more inflation and higher real taxes.

Where Do We Go From Here?

Our problems are long-term problems. Inflation is more than ten years old and will not end soon. Investment has lagged for several years. It will not soon spurt ahead and remain high. Productivity is rising, but the rate of increase is below average of the sixties.

None of these problems can be solved by intense concentration on next quarter, next year or the next election. They can only be solved by policies that are able to achieve lower future taxes, less inflation, greater incentive to work and save, less regulation and fewer controls.

The President and those responsible for economic policy must see that investors and financial markets have voted no confidence in their measures. Stopgaps and stimulants will not succeed and will not generate confidence. Tired metaphors about freight trains accompanying pleas to Germany and Japan for help do not inspire confidence or encourage cooperation. More of the same will not solve any long-term problem.

If the government will not plan its own activities and make a public commitment to policies that achieve stability, the private sector will not expect stability. Inflation will remain high, investment low, and we will continue to drift.