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THE ECONOMIC RISKS OF 1978

Remarks of

Philip E. Coldwell

Member, Board of Governors of the Federal Reserve System

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There are two rather old sayings that when things get very difficult the individual is between a rock and a hard place or there is a Mexican standoff between two unacceptable choices. In a way these old sayings describe what some observers see as the economic alternatives of the United States with the choice of economic and financial policies likely to set the course of the economy toward recession, inflation, or possibly both. Let us examine the evidence to see if indeed these are our only choices.

As the United States enters its fourth year of economic recovery, current conditions seem highly favorable. Real Gross National Product has advanced more than 12 percent in the past two years and the annual growth rate over the first two quarters of 1978 is likely to average almost 5 percent. Reactions to the cold weather, the coal strike, the depreciation of the dollar, and the sharp rise in food prices have contributed to a sharp economic rebound, but a growing uncertainty with regard to inflation and the prospects for the coming year.

Let us look at where we are today. The nation's industrial production has been growing sharply out of the first quarter slump, housing starts have recovered and are now back over the two million unit level, and retail trade and particularly automobile sales have been quite strong. But, on the other side of the ledger, prices have been rising in the first few months of the year at almost double digit annual rates and money supply skyrocketed in April.

Some observers believe these new gains are merely catch up or reaction to the unsettling conditions of January and February. Others see them as forerunners of a new trend in the U.S. economy, with a renewed burst to a potential overutilization of its resources and, therefore, a threatening position in relation to the U.S. financial picture.

Let us see if we can abstract from the first and second quarter aberrations and describe the fundamental trends of the economy so that we may get a somewhat better perspective on which way we are going.

Consumer income and spending have been strong over the past year with consumer credit advancing sharply and consumer durable buying in a strong position. Wages have more than kept up with price changes and unit labor costs have been rising sharply as productivity slumped. In the fundamental areas of private domestic investment, the U.S. has been riding a very high level of housing construction and a perceptibly growing level of capital spending, particularly in the fields of commercial construction. What has been lacking until the past few months, has been any real sign that basic capacity expansion was moving ahead at an acceptable pace. This now appears to be coming on stream, although with some continued hesitancy and still at a fairly modest pace. Business inventories have been kept in very close alignment with sales, though recent trends of accumulation must be watched carefully. Government spending has been falling short of its projected totals at the Federal level and State and local Governments in total have been showing large budget surpluses. Despite all the talk about heavy deficits, the Government's fiscal position has not yet provided the degree of stimulus which some economists have feared.

Internationally, the U.S. export-import relationship worsened in the first quarter. But with the depreciation of the dollar last year and the potential impact of that upon exports, along with a possible dampening of demand for the higher priced imports, there is some optimism that the U.S. trade deficit may moderate in the latter part of this year.

All of these various trends and pressures on the economy have been reflected in the loan demand and financial trends of the nation. Business loan demands at banks have accelerated to more than a 15 percent annual rate and with that a strong pressure for greater money supply to handle the transactions created in this booming U.S. economy. Interest rates have moved up and money supply data reflect the magnitude of the expansion.

Federal Reserve monetary policy has been slowly accentuating its resistance to the higher growth of money supply.

Since the first of 1978 monetary policy has taken two discreet steps toward restraint--first, in January when the discount rate and market rates were nudged upward to attempt to provide some strength to the dollar rate of exchange. Second, in late April and early May, rates were again moved upward to counter the reappearance of rising inflation and higher than desired rates of money supply and to further aid the international recovery of the dollar.

There is little disagreement about the posture of the U.S. economy at the moment. It has been expanding for more than three years from the trough of the recession and now has clearly moved into new high ground relative to the previous peak performance and relative to the growth of the economies of many other nations. There remains some unused capacity, both in human and material resources, but the appearance or interpretation of the degree of unused capacity is subject to considerable dispute among the major interpreters and forecasters of U.S. economic conditions. For example, the unused capacity of business plant and equipment measured at about 16 to 17 percent is to some observers a degree of flexibility for further expansion and a cushion for further growth. To others, these same data indicate a position bordering on full utilization of our plant and equipment. They view our present capacity measures as both inadequate and poorly descriptive of the current state of productive capabilities.

If one accepts the first interpretation, the expansion of the U.S. economy should not slow nor be curtailed from its high relative growth, because there are sufficient unused resources to provide for further expansion without excessive inflationary pressures. These high-road expansionists want the economy unfettered and wish to see further sizable gains in production, further appreciable reductions in unemployment, and less pressure upon interest rates and other restraining devices because they believe that the capacity is available to accommodate a higher level of production and growth before any restraints are needed. To a considerable extent this group is reluctant to restrain U.S. money supply growth because they still see the need for expansion and do not wish to have interest rates begin to hamper the continued expansion or growth of either housing or capital investment. This position reflects a belief that we are now seeing primarily a rebound in the economy from the effects of the cold weather and coal strike. This view also presupposes we are suffering from a temporary food price problem rather than a fundamental increase in the inflationary pressures. The expansionists may be willing to reduce the budget deficit and Government stimulus to the economy as a minor protection against the possibility that they are wrong. But clearly, their policy attitude risks the further enlargement of inflationary pressures and renewed depreciation of the dollar in foreign exchange markets.

On the other hand, one might accept the second interpretation of the U.S. economic status. In this view, the margin of unused capacity is much narrower than the figures portray and structural changes are not reflected in U.S. data on the rate of unemployment and the rate of capacity utilization. In the unemployment area, this approach portrays the nation as rapidly approaching full employment. The margin between the current unemployment rate and one corresponding to more normal frictional unemployment, is now within one-half of one percentage point. To employ more teenagers or more women specific programs are needed to avoid risking extremely high inflation. In other words, macro-economic stimulus should not be used to force enlargement of new job opportunities. In the capacity utilization field, this second approach indicates that the nation's stock of plant and equipment has become more obsolete in the past five years than the published data show and that the true level of capacity is much closer to the present utilization rate.

These conclusions regarding unemployment and capacity utilization, coupled with a feeling that a rising fiscal deficit provides excessive stimulus, foster a policy position of demanding significant restraint upon the economy to hold down further growth in the money supply and to restrain aggregate demand so that inflation is dampened and thus the nation will not face a serious downturn at a later point. This position, of course, risks an early slowdown in the rate of economic expansion, perhaps to less than a 3 percent growth rate by late 1978. In effect, adherents to this position are opting for a growth recession rather than to risk a major recession later on.

Some in this group believe that recession is already inevitable. To them, the pattern of change in the growth of money supply and the restraints being placed on the cost and availability of credit have already made some form of recession likely in the next twelve months. Such a slowdown is viewed as both inevitable and desirable to preclude a larger recession. The recession is accepted as a means of slowing the growth of both unit labor costs and the acceleration of price increases. The risks of this policy prescription are obvious. The U.S. would again begin a recession but our ability to limit the degree of such downturns has not been noticeably successful. The inflationary aftereffects coming out of a recession with massive stimulus both in money supply and fiscal actions clearly make such an approach a high-risk road. Yet the expansionary policies advocated by the first group pose an equally difficult risk pattern of very high inflation rates and a potentially greater recession at a later point.

In between these extreme policy paths are many in the U.S. Government today. They hope for a lessened, more sustainable rate of economic growth in this fourth year of recovery and yet one that does not reestablish the pattern of recession, rising unemployment and massive Government stimulus. For this group the U.S. economy is in an intermediate position. They accept the idea that inflation is growing too fast at the moment. But they hope and expect that the rate of inflation will ease in the later part of the year as it has done in prior years and hope that the principal accelerator to such inflationary trends has been the more random moves of agricultural prices and perhaps a few other raw material prices, rather than a new broadly-based inflationary pressure.

Adherents stress the idea that wages are a major stimulant to further inflation and pattern their policy response toward attempting to reduce wage pressures in order to achieve price restraint. Some of these individuals believe that the pressures of monetary policy with higher interest rates to restrain money supply have been a factor in the acceleration of inflation these past few months and that further monetary policy restraints could clearly place housing and capital spending programs in serious jeopardy. Consequently, the policies espoused by this group are those trending more toward incomes policies requesting cooperative restraint on the part of business, labor, and Government to effect a reduction in the level of inflation while continuing to expand the U.S. economy. Nevertheless, to many, the current degree of restraint by monetary policy is acceptable but further restraint is viewed as creating a high risk of early recession. The group favors a reduced fiscal stimulus with a cancellation or deferment of tax cut programs, a rolling back of certain tax increases already scheduled for early 1979 and a general governmental policy of restraint on expenditures.

Critics of this policy posture view the possible results as the worst of both worlds. They argue that further inflationary pressures coming from both wages and raw material price areas will be inadequately diminished by voluntary action and suggest that such a pattern could lead to a less voluntary program. They also see such a policy prescription as permitting higher inflationary rates without monetary restraints as building a base for future inflation at rates clearly unacceptable to the American public and to Government itself. These halfway-house advocates are told that fiscal policy, even if curtailed in the initial period, would likely be expanded as the near-term performance of the economy worsened and that expansion of the nation's economy over the remainder of the year might build such an acceleration as to force major curtailments later on.

And what does all this mean to you in the banking industry in late spring of 1978? Well it means that you must plan with a great deal of care. If you agree with the high-road expansion group, then plan for further loan demand, higher profits, and great earnings capacity and potential. If you agree with the restrictive group, then plan that interest rate increases will slow the growth of economy, reduce loan demand and place you in a greater liquidity position toward early 1979. And what if you agree with those in between the two, there you pay your dime and take your chances. If one looks at the business cycles over the past 25 years, the pattern of expansion and recession is, of course, striking. If this is a guide to our future, we have not learned the magic of balanced growth. If our politicians are still to be subject to the insistent pressure of constituents for expanded Government spending, we have not learned the lesson of a balanced budget. If monetary policymakers must continue to restrain our excesses, the elixir of economic stabilization will elude us. One must hope for a better solution and perhaps we could find it by less interference with the economy, less Government spending and more stable monetary and fiscal policies.

For now though, the risks are so high and the pattern of expansion so far advanced that the cyclical process or pattern will be difficult to contain. Nevertheless, aggressive efforts to reduce Federal expenditures, and eliminate any additional stimulus by tax cuts or other measures, could provide the immediate margin of flexibility to improve the odds for a sustained economic expansion.

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