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ECONOMIC PROSPECTS AND POLICIES

Remarks of

Philip E. Coldwell

Member

Board of Governors

of the

Federal Reserve System

Before

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of the
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at the
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ECONOMIC PROSPECTS AND POLICIES

It is no news to anyone in this room that the United States and, in fact, most of the nations in the world have been involved with a serious problem of inflation in the past year. It is probably fruitless to spend any significant amount of time assessing the blame for inflation, so let us merely say that there have been significant internal and external forces at work which have bred and accelerated the inflationary problem we have faced since the end of World War II. Even the broadest measure of inflation for the United States is now advancing in the 10 to 12% range. The purpose of my speech tonight is not to dwell on the historic record of this inflation, but instead to visit with you about current economic and financial conditions and the corrective forces under way which we hope will dampen the inflationary surge without forcing the United States into a deep recession.

From my present vantage point I believe that our economy is still operating at a very high level though there have been significant internal shifts among its principal sectors. If one wishes to seek the silver lining in the current situation it can be found in the high level of industrial production which is almost the same as a year ago, the high level of employment in the nation as a whole, and the strong capital spending for new plant capacity. Industrial production as measured by the Federal Reserve index shows total production in physical terms at about the same high level as in the early fall of 1973 and

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within 2% of its record peak. Within this total picture, durable goods production has shown some considerable declines especially in transportation equipment and lumber production. These declines have been offset to some degree by high levels of fabricated metals and machinery output as well as rising business equipment and instrument production. Nondurable goods production is relatively steady in total, with strength in chemicals, rubber, and food output. Mining output as a total has declined, especially in the metal segments. The high level of economic activity is currently supporting employment levels of 86.5 million people, some 853,000 more than a year earlier. Capital spending by major businesses has advanced sharply by 12.5% in the past year and continues to support much of the rising equipment and industrial construction sectors.

If one seeks the darker face of the current economic scene, however, it is evident that the construction industry as a total, and especially housing, has been seriously curtailed by the rising cost of raw materials and, ultimately, the total cost of the finished project, by the high level of interest rates and by the lessened availability of credit. The strength in industrial production can be interpreted as originating primarily from the strong surge in inventory growth which, though difficult to measure, is now believed to be excessive in some industries and segments of the distribution process. Similarly, labor conditions can be placed in an unfavorable light by reflecting on the rising level of unemployment, reduced average

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work-week and declining level of overtime. Although the civilian labor force has expanded by more than 2 million people over the past year, over half of this growth has gone into the increase in unemployment. One could also look at the trends in retail trade which though nominally up more than 10% over a year ago, have in real terms been declining for more than a year. New orders have begun to weaken and inventories have become burdensome. In addition, economic and political uncertainties have taken a heavy toll in the confidence of our people.

If current economic conditions can be so diversely interpreted, there is even a greater problem in the financial industries. In the broad picture, it is clear that our financial institutions have provided the credit for continued expansion of our economy, but only at generally rising interest rates and with some considerable differences among various sectors as to availability of credit. Credit demands for inventory have been a substantial part of the overall total demand as have the demands of major industries for capital spending purposes. More recently, credit demands have eased somewhat, especially with the slower growth of inventories but reflecting also the monetary restraint placed on the economy by the nation's central bank. As these demands have eased, and the growth of the nation's money supply has slowed, interest rates have begun to decline. Financial uncertainties and disruptions have taken their toll in some businesses and in the general illiquidity of a good many financial and nonfinancial concerns.

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Simultaneously, the high cost of credit has cast a cloud over the financial prospects of a good many major projects, rendering their long-term viability subject to considerable question. Perhaps the blackest interpretation of the current financial scene would emphasize the strained posture of some financial institutions stemming from the years of heavy credit accommodation and the build-up of credit commitments.

Inextricably linked to the domestic financial scene are the international aspects of the current situation. Excessively large exchange rate volatility has induced great uncertainty and has disrupted long-term stable relationships among currencies. But overriding the international scene are the continued ramifications of the major oil price changes in the past year. The large official reserve accumulations and balance of payment surpluses of the OPEC countries and the distressingly large deficits of the oil consuming nations threaten the long-term viability of international trade as well as the financial strength of a good many nations. Petrodollar recycling would merely defer the central financial problem which must be faced, and in effect, postpone the impact on nations borrowing funds for day-to-day living expenses.

In this period of chaos, uncertainty, and instability, one is tempted to throw up his hands and say that the problems are insoluble. But most of us recognize the stabilizing forces at work

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in our economy and the fundamental strengths of our economic system, which appear to provide a great capacity for growth, despite interference, instabilities and uncertainties bred from political and economic policy determinations. The economic future for 1975 in the eyes of a good many observers, can be expressed in one of three scenarios. On one extreme, a number of economists and political forecasters see a deep recession with steadily weaker real growth, continued high level inflation and a possible severe crisis in international trade. At the other extreme, a few economists are anticipating a prompt recovery in our economy starting in early 1975 with a resumption of real economic growth and declining unemployment. Such a scene would encompass the beginnings of higher employment, growth in industrial production, early recovery in the housing industry, and a sharp reduction in the rate of inflation. Undoubtedly, this is the most optimistic view of any current forecast. To the vast majority of forecasters, however, the probable course of the nation's economy in the coming months lies between these two extremes. Such a middle ground forecasts further but milder declines in our economy through mid-1975 and the slow resumption of real growth late in the year. This recovery would be accompanied by a slow correction to inflation, probably much slower than most would prefer, and an equally slow and unsatisfactory reduction in unemployment.

In light of these various possible courses for the future of the economy, those of us involved in economic stabilization efforts

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have a significant problem of policy response. We can already see that the effects of inflation and stabilization policies have brought the highest level of interest rates in this century, have significantly dampened the availability of credit and have set in train a series of corrective actions in the field of inventory adjustments as well as concellation of projects which has dampened the growth of the American economy and has, in effect, fostered some retrenchment.

We recognize the considerable depressing effects of the inflation itself. The substantially higher prices for oil, food and other routine purchases of the American consumer have severely reduced discretionary incomes and this reduction is being felt in lower purchases of big ticket items, new automobiles and, in fact, the full range of consumer expenditures. To some extent the wage earner has been able to offset the effect of inflation by higher wages, but this offset is far from perfect and the dampening effect of a reduced level of discretionary income is also reflected in a slower rate of savings and in protective investments in land and other inflation hedges. In other words, there is a built-in corrective to inflation by the inflation itself, and while this corrective is neither perfectly equitable among all sectors of this economy or all segments of the work force, there is a considerable impact which eventually slows the economy and dampens inflationary pressures.

It has been the role of monetary and fiscal policies to attempt to speed this dampening effect and thus achieve a more rapid

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correction than that which develops from the sheer effect of prices on discretionary income. But economic stabilization policies must be handled with great care so that the dampening effects do not exceed the limits of tolerance and force a hasty retrenchment into recession. Thus, it is the job of the Federal Reserve and other elements of the Government to appraise both the near-term and intermediate prospects of the economy and adjust their policies to fit those prospects. It should be recognized that the impact of such governmental policies is applicable only with some considerable lag and given this lag, policies must be adjusted before the immediate desired economic change is visible.

Returning then to the scenarios for the economy as stated earlier, it is apparent that if the nation is headed for a deep recession, monetary and fiscal policies of the nation should be adjusted fairly rapidly to a posture of stimulation. On the other hand, if the dampening effects of the internal correctives of the inflation and the restraining pressures of present policies have indeed accomplished their purposes and the economy is headed toward a near-term recovery, such policies would need only to be adjusted to an accommodating posture permitting advancement but not stimulation. However, if the corrective actions of the past have not truly dampened the inflationary pressures, government policy must still maintain a restrictive posture modified to protect against an excessive reduction in real income. Thus the projections for the economy are interwoven into the prospects

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for policy determination and such prospects range from moderate restraint to outright stimulation.

If our total job were that only of correcting problems originating with our domestic economy, policy problems could be confined to this decision area. But the international complications in the present situation and the tendency for most major industrial countries to be on a parallel cyclical track severely complicate the policy determinations of the United States. We must not only deliver the most desirable policy posture for domestic correctives and ultimate real growth, but must also adjust those policies to achieve a desirable policy posture in relationship to other nations both in trade and international exchange. At present it does not appear that these two areas of policy would be in conflict. Thus, what would appear to be needed for domestic purposes may also be needed for international policy purposes. However, there are potentials for conflict which might develop in these two areas when such policies impact upon interest rate relationships and the effects of recycling petrodollars. While the latter is not a policy determination for the Federal Reserve, it is a matter of considerable significance and one in which the Federal Reserve provides some input to our national policy.

Obviously, our desired solution would be a reduction in oil prices but political considerations and national aspirations of the oil producing countries make this solution difficult at least for the immediate future. Thus the question of recycling becomes

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of great significance. Under one possible course the United States could receive the funds back from the oil producing nations and reloan them to the oil consuming nations. Such a course would involve potential U.S. liability for such loans and it is quite doubtful that we should accept such liabilities over the long haul. Another course of action might be for the dollars to be recycled through U.S. commercial banks using their deposit absorbing capabilities and lending possibilities to shift such funds back to the oil consuming nations. Again the acceptance of lending liabilities would make such a course of action unpalatable. Any forseeable course of action on recycling is likely to involve questions of equity, balancing the import cost of oil with the availability of loans to support continued purchases, as well as the additional cost of borrowing and the long range difficulties of continued borrowing for daily consumption. In my view, continued recycling will create an unacceptable long range debt structure for most oil consuming nations which might bring about some reduction in liabilities by means of changing exchange rate relationships, restrictions on international payments, or even debt cancellations.

Domestically, the economic stabilization policies of our government will need to tread the very thin line between continued pressure against inflation, but accommodation to resist a deep recession. To the business and consuming public of the United States, such a policy posture could result in an unsatisfactory growth in real output, a higher than desired level of unemployment, and a higher than the desired level of inflation for some period of time.

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Responsible business and labor policies to reduce the pressures on prices would be of immense help to shorten this time of adjustment.

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