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FINANCIAL PROSPECTS

Remarks of

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Financial Prospects

The United States has just finished a very unusual year. Our economy was buffeted by major changes in prices with the cost of living up 12 per cent, by interest rate movements, to peak levels in July and then rapid declines in the short area, and by an intense demand for credit emanating from the needs of business to finance major inventory increases and to meet the ongoing and rising costs of production. The year 1974 was also unusual in the political arena as a mid-term change in Presidents was accompanied by investigations, and the uncertainties involved in that shift. But our review today centers on the economy and I think we should look carefully at the causes of some of the unusual economic trends and see if we can search out some of the clues to the direction of the economy for 1975.

The rapid inflation of 1974 was rooted in the excess demand of the 1966 decision to finance the Vietnam war without tax increases and the wage cost push of the late 1960's stemming from that war decision. These led us into the 1970's in a rising mode of prices and some considerable deterioration in our competitive ability to market goods and services abroad. The extremities of inflation during 1974 also stemmed from international factors. In the background the two devaluations of 1971 and 1973, the deterioration in our exchange rate position, and the poor agricultural crops of 1973, led to rather intense price pressures. Finally, of course, the quadrupling oil

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prices sparked a cost-push from international sources which ramified in virtually all major production and consumption components. It is difficult to overemphasize the importance of this oil price action because virtually all production and consumption in the United States has been founded upon a steady and abundant supply of cheap energy. Therefore, with oil and other energy forms moving up so rapidly in price, there developed a major cost-push to the prices of all energy-related commodities and even to unrelated commodities which use transportation and energy.

But the extreme inflation brought its own pressures to bear on our economy as the expansion of credit needs to finance the purchasing of raw materials and to meet the rising costs of energy, wages, and other basic materials brought exceptional demands upon the financing institutions of our nation and upon the money markets and credit markets of the country. These heavy pressures on credit markets resulted partly from the increased demand and partly from the monetary policy of restraint which reduced the supply of credit at the very time when the demand was accelerating. Part of the explanation of the intense pressure on the banking industry must be found in the relationship of the rates of interest being paid on commercial paper against those on bank credit. As commercial paper rates moved higher than bank prime rates, companies shifted their credit demands to the banks.

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Together, however, the large credit demands on a limited supply of funds brought intense interest rate pressure and the price of credit moved rapidly upwards. Most of this very high interest rate movement was an inflation premium. If one assumes that the basic cost of money is between 3 and 4 per cent, then the U.S. companies and individuals were paying at the peak of rates, an inflation premium of 8 to 9 per cent. Such a premium was demanded to equate the value of the dollar loaned to the value of the repayment.

Another element in the unusual character of this financial market was the well publicized failure of some large banking units, and the public skepticism about others as rumors abounded through the industry. I might digress here for a moment to comment that the financial industry has done itself a major disservice in 1974 by continuous comments on the weaker units. This gossip has hampered the regulatory authorities' possibilities of saving these units from major difficulties. It is clear that when a bank or other financial institution develops a position of exposure, there is great comment about its liquidity, if not its viability. Such comments lead to termination of large CD contracts, cessation of sales of federal funds, and withdrawal of correspondent accounts. These actions, of course, aggravate the situation and, especially near statement dates, bring the weakened position to the public eye. Usually the relevant regulatory body is already working with the disadvantaged bank to

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repair its position but,when public notice of the problem develops, there is an uncertainty created which often develops into a significant withdrawal of deposits. This clearly complicates the situation and reduces chances of a smooth resolution of the problem.

As late as October, the President of the United States and most other observers of the economic and financial scene were still distressed about the rate of inflation and were recommending or advocating policies designed to reduce inflationary pressures. We now know, of course, that a recession was underway in the latter half of 1974 which became more intense by late fall.

It is instructive to look at the causes of this recession which are many. Certainly the weakened consumer income position from the high cost of food and energy purchases, coupled with wage-earners' inability to counterbalance their loss of discretionary income, caused a significant cutback in consumer demand. Simultaneously, the debilitating drag of steadily higher prices and an outlook for continuing inflation, induced consumer and business caution toward future purchases of goods and capital spending for increased capacity. As expectations dimmed, so did the actions which might have sustained economic progress. Consumers became uncertain of their economic future and further curtailed deferrable major durable purchases. The cutback in consumer demand, especially in automobiles and other durable

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good products brought a sharp reduction in orders. Responding to the situation, businesses reappraised their orders which contained a considerable degree of double ordering, evidenced by a great deal of fluff in the sense that the availability became so prompt as to permit the reduction of other orders which had been placed to assure continuation of the production process.

Final product inventories became burdensome in relation to lowering sales and resulted in a severe cut in production and a rapid layoff of workers. The continued cost-push from high energy prices echoed throughout the economy and workers sought higher wages to protect their buying power. Simultaneously, of course, pressure upon credit markets developed from the restrictive monetary policies and the ramifications of these policies along with the pressures from the declining discretionary income developed the recessionary trends in most nations. In essence, then, we can say that the development of recession in the United States was a result of not only the long-term inflationary forces of the past decade, but also the very sharp upward surge in prices during 1973-74 which laid the counteractive base of a downward move in production and employment. Aiding and abetting this decline was the reduction in credit availability from the anti-inflationary moves of fiscal and monetary policy.

As recession deepened in the fall of 1974, there was a major shift in policies both for the private and the public sectors. The private sector reflected the change in consumers' demand for products, while the producers cut production on goods and services.

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On the public side, fiscal policy began to shift as the President moved his position from counteracting inflation by tax increases to resisting recession by enlarged job programs and tax cuts. Simultaneously, of course, the built-in stabilizers reduced tax revenues and increased unemployment insurance payments resulting in sizably enlarged government deficits and thus fiscal stimulation. Monetary policy, too, began to ease as policy shifted toward a greater provision of credit.

Thus, by the start of 1975, the U.S. economy showed a mixed picture of both inflation and recession. The easing of monetary policy and the resultant declines in short-term interest rates brought a resumption of savings flows to the thrift institutions and enabled them to begin repayment of borrowings which they had accumulated over this period of tight credit availability. Similarly, banks found a sharp improvement in their liquidity and with a greater provision of reserves by the Federal Reserve and a lowered demand for credit, began to repay their borrowings and increase cash and short portfolio positions.

Interest rates in short-term areas declined rapidly in the last half of 1974 so that by early February 1975 Treasury bill rates were in the mid-five per cent range against a July position in excess of nine per cent. Federal funds, which in July 1974 had reached a peak of 13-1/2 per cent, were hovering in a low 6 per cent range by February. On the other hand, the long-term markets had not changed nearly so

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dramatically. Long-term rates began to ease somewhat and even mortgage interest rates declined somewhat by early 1975. But the rate of decline was much slower than for short-term funds. In the basic economy, major production cutbacks and employee layoffs were frequent in the early part of this year and consumer and business sentiment was especially adverse.

While the inflation was in large part responsible for the developing recession, the recession also contains the seeds of recovery. The resumption of savings flows to thrift institutions brought into prospect a reversal of the housing decline and even the possibilities of higher levels of housing construction toward the spring and summer. Cutbacks in production beyond the current level of demand appear to be causing the start of a liquidation of inventories. With the cutbacks in output the costs of production fell, and with inventory liquidation the cost of financing inventories began to decline. Thus prospects are starting to develop for higher production levels later in the year. Even the expectations of consumers and businessmen, though especially bleak in the early part of 1975, may be starting to improve. These changes were manifest in the sharp stock price increases of late January. Aiding and abetting these changes were the materially-lower short-term interest rates, the improved liquidity of banks, and the incentives for both personal spending and business investment, evident in proposed tax reductions.

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Well, where do we go from here? The prospects for 1975 range from the optimistic to pessimistic forecasts. To the optimist, the economic scenario for 1975 would run something like this. Inventory liquidity should occur in the first two quarters of 1975 and capital spending will be stimulated by new investment tax credits while consumer demand will be improved by a personal income tax cut. With inventories reduced, recovery in production would develop by mid-summer, while inflation rates decline and unemployment stabilizes. Simultaneously, housing demand, led by increased availability of credit and some reduction in cost of raw materials, would be re-stimulated resulting in some considerable improvement in the construction industry. Such stimulation is expected to be well timed and moderate so that inflationary pressures are not regenerated. The optimist looks for international stability in exchange rates, no major political or military confrontations, and no significant price increases in raw materials such as oil. This happy viewpoint presents 1975 as the starting point for another long period of stability and progress.

To the pessimist, the economic scenario would be quite different. Some stimulative actions would be felt in the economy in 1975, but over the long run, the stimulation would fail because consumers feel a threat to the value of their currency and being so conditioned by the inflationary excesses of 1974 would view the stimulation as resulting in debt monetization and renewed demand

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pressures. Therefore, only a short-term real recovery is expected by the pessimist. In fact, the pessimist would view such stimulative action as ultimately weakening demand conditions and turning expectations to an even deeper position. The pessimist would expect the recession abroad to cumulate, forcing a severe curtailment of world trade. He may also expect that as inflation accelerates additional price increases by the oil-producing countries would cause a further rapid price inflation in the oil-consuming nations. This, to the pessimist, would cause further curtailments in production and employment and the world would shift to isolationist recessions.

Obviously, if we portray these scenarios in such drastic terms, the extreme forecasts of the optimists and pessimists are unlikely so that a middle ground forecast is more reasonable. To the probable majority of forecasters who see the future between these extremes, the stimulative efforts of government are likely to have some beneficial effect and at least bring a halt to the downward slide in the economy with perhaps a modest recovery pattern in the latter part of the year. But the middle ground position would indicate stimulation, bringing very large government deficits and financing of these deficits would put the Federal Government in a position of crowding out a number of the private financing efforts. Thus, private demand recovery would be dampened and unless the Federal Reserve made such massive increases of credit available so that both groups could meet their financing needs, the private recovery would

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be slowed. At the same time, the intermediate forecaster would view these massive credit demands as presaging another inflationary bout as Federal Reserve credit mounted and money supply provided the wherewithal to finance goods and services at ever increasing prices. Even with easy credit conditions, interest rates might turn upward again as inflationary pressures increased. Recovery would be slowed until a better balance is achieved and housing recovery probably would be aborted by the rising interest rates.

To me the possibilities are strongest for a blending of the forecasts of the optimists and the intermediate. I hope for the optimists' scenario, but fear that some of the elements of the scenario of the moderates may prove to be correct. Thus, from my vantage point, I am basically optimistic that we can restimulate our economy, develop a recovery, and have an opportunity for balanced growth in the years ahead. But unless we are careful in the handling of public and private policies, we may overstimulate, thus reinforcing the pressures of inflation and aborting recovery by higher interest rates or reduced credit availability.

It will indeed be a precision-timing effort for all sectors of the economy if we are to avoid creating a new inflationary base of excess credit, while stimulating the economy enough to generate recovery. As I view the problem, it is primarily a matter of degree, timing, and patience. Sufficient monetary and fiscal stimulation

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is needed for recovery but an excess will overstimulate and provide the credit for another round of demand inflation.

Timing is critical to the whole exercise. If stimulative efforts can be applied on the downside or trough of the recession, they will encourage recovery in housing, consumer demand, and capital spending at the appropriate time. But if the stimulative effects are delayed by either enactment or implementation, they could be in full force after recovery starts and thus so accelerate the economy as to cause regeneration of inflationary pressures.

Patience is the third important element. If businesses, unions, consumers, or Government become impatient for early and rapid recovery, their attitudes could trigger new stimulative efforts beyond those already discussed. If, however, they remain patient and moderate in their demands there is a strong possibility that recovery will usher in a new equilibrium from which economic progress can be expected by all. The voices of moderation in economic policy need to be heard most loudly and insistently to overcome those who would reflate without thought for tomorrow or those who would enslave public policy to a single measure of progress. The latter groups include those blind to all but the unemployment rate, the change in money supply, the level of interest rates, the rate of housing starts or the consumer price index. All such measures provide some insight into the health, progress, or change in our economy but no single one

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can characterize the whole economic scene and none should be used in isolation or as the sole guide to public policy. In my opinion, the search for a push-button, statistically-triggered, single-measurement policy, may lead down the road to excessive reactions, controls, and the loss of responsive independent judgmental analysis.

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