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THE ECONOMIC AND MONETARY OUTLOOK

Remarks of

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The Economic and Monetary Outlook

The United States economy has weathered a major inventory recession resulting in part from a long downturn in consumer spending and a major contraction in home building. The recovery from this recession is now well established and with only two major exceptions, unemployment and capital spending, shows a balanced advance. Of course, most major economic indicators measured in dollars are well above their previous peaks and many measured in physical units or real dollars are also at new record levels. Just to remind ourselves, perhaps we should first review how far we have come since the trough of the recession and our progress since the first of 1976.

Real gross national product is up nearly $100 billion or 8-1/2 percent since the trough of the first quarter of 1975, and since the fourth quarter of 1975 has advanced 3.3 percent. Real gross national product in the second quarter of 1976 is 1.4 percent above the prior peak of the fourth quarter of 1973. In similar fashion, industrial production in July of 1976 shows a 16.7 percent increase over the trough of March of 1975 and since the end of 1975 has shown an increase of 4.8 percent. However, industrial production has still not recovered to the prior peak which occurred in June 1974. New housing starts have shown a remarkable recovery from an extremely depressed level at the trough and in July 1976 were more than 57 percent higher than that trough. Since December of 1975 they have advanced 8.1 percent.

However, new housing starts have not yet recovered their prior peak by a substantial margin and as of July of 1976 are still 44 percent below the peak of November 1972.

The data cited already clearly show a marked recovery from the recession by most of the productive elements in our economy. With this has come a major advance in the labor force and total employment. Just since December of 1975, the labor force has grown by 2.2 million people, or 2.4 percent. Employment has advanced similarly and the July 1976 level of 87.9 million total employment is 4-1/2 percent above the trough of March 1975 and 2.9 percent above December 1975. Total employment now exceeds its prior peak by 1.9 percent. All components within the employment totals, however, have not shown an equivalent rate of advance. In manufacturing, the July level for payroll employment is still 7 percent below the prior peak of December 1973, even though the July 1976 level is 4.7 percent above July 1975.

The major area of the economy which has not yet improved at the pace one might have expected in this type of recovery has been the rate of capital spending. Mainly as a result, the rate of rise of real GNP has lagged the average postwar recovery. In another sense, this recovery is unusual: the unemployment rate of 7.9 percent in August of 1976 is still only one percentage point below the peak of 8.9 percent registered in May of 1975, and certainly has not returned to its prior low level of 4.7 percent in October 1973. In fact, since the end of 1975, the unemployment rate has improved by only four-tenths of one percent.

Capital spending has similarly lagged during the recovery with the total 1976 anticipated plant and equipment expenditures only 7.4 percent above 1975 levels. At the projected level such capital spending in real terms would be only marginally higher than a year earlier. But the survey indicates continued growth in upcoming quarters, as does the recent strength in new orders for nondefense capital goods.

There is one other major bright spot in the economy. Some major improvement has occurred in the rate of inflation. The consumer price index during the past year from July 1975 to July 1976 has shown an increase of only 5.4 percent whereas the year-to-year advance to July 1975 was 9.6 percent and the year before that showed an 11.5 percent advance.

The gains in the economic recovery have been partly reflected on the financial side. Certainly the liquidity of both financial and nonfinancial firms has improved very sharply and interest rates have declined sharply from their peak levels of the prior period of heavy demand and monetary restraint. Business loan demand, however, has shown a remarkable weakness for many months. With advancing liquidity in the economy, the debt management job of the Treasury has been handled in a reasonable and timely fashion even though the deficit of our Federal Government has gone beyond $68 billion in the past fiscal year. Monetary policy has played its role in easing the pressures on reserves and permitting a lower level of short and intermediate-term interest rates, while supplying liquidity to the financial institutions to meet the carry-over problems from the recession.

Given the above pattern and the picture of the economy today, one could reasonably conclude that everything was right with the recovery and that the U.S. economy was going to advance in a clear and unmistakable fashion in both a balanced and orderly manner. But these conclusions might not be those of a close observer of the nation's economy. There are important questions concerning the economic outlook and some of these are the ones which we need to consider in developing a scenario for the future in both the economic and monetary outlook.

First among these questions is a residual from the past few months when consumers decided that they would not continue the same rate of spending but instead would place more of their funds into savings. These decisions have meant a lower rate of retail sales advance and in some months even a decline. They have also meant that inventory levels, which in prior periods looked as though further accumulation would be in order to meet the advancing sales totals, suddenly threatened to become involuntarily burdensome and consequently producers of some goods began to trim back their production schedules. The consumer led the American economy into and out of the recession of 1974-75, but there now seems to be some question as to whether that stimulant can be relied upon for the same rate of advance in the near-term future. If the consumer continues reticent about his level of spending, then the rate of advance in gross national product, the rate of inventory accumulation, the level of industrial production and indeed the vigor of the whole recovery could be called into question. However, current evidence cannot sustain a forecast of continued weakening especially in view of the rising retail sales picture in August. Moreover, the rate of personal income gain is still high. Wage increases are developing at a rate perhaps more than warranted under the current circumstances, but these do provide high levels of personal income and should provide the basic wherewithal for further advances in consumer spending.

Our second major question is, whether businesses will need substantially greater short-term credit accommodations? Many businesses have accumulated sizable amounts of liquidity through long-term bond and stock issues and regular cash flows which are permitting them to cover expenditures for daily operations and even lay away funds for some capital additions. Under these conditions an early return to the banking system for significant amounts of credit is likely only with a major expansion in inventories and this could be sustained only if final demand were to show evidence of continued sizable growth, and if the cost of bank credit were to be competitive with the commercial paper market.

Further caveats to enlarged business loan demand are the expectations of businessmen concerning the durability of the recovery, the prospective tax situation, and the willingness of banks to accommodate such loan advances. Of course, the business community is made up of large and small, weak and strong, and progressive and slow businesses. Some businesses have access to many other sources of credit while many weak or small ones must rely on bank credit. Thus any broad statement on business loan demand at banks suffers from the diversity of position of the business community and its banking connections.

On another vital question, whether capital advances will be forthcoming from business in the near future, the evidence to date is not yet decisive. We know, for example, that new orders for capital equipment are coming in at a fairly good clip, but we also know that the plans for new capital spending are still relatively weak, compared with the prior investment boom of the sixties and the early seventies. Capital spending will need to be at a much higher level than is presently visible if the economic expansion is to continue into the years ahead.

Finally, it seems to me that the possibilities of continued balanced expansion will be heavily influenced by the handling of fiscal and monetary policies. There is an outside possibility that the recovery may weaken, thus generating a need for additional stimulants. If advances in consumer spending and business capital additions prove to be inadequate, and the recovery weakens, then the environment within which business will be working will be even more difficult and more problematical than today's.

In view of the critical character of the fiscal and monetary policy actions over the coming months, a review of the primary factors influencing each of these seems warranted. In the fiscal policy area, Congress apparently seems aimed at a budget for fiscal year 1977 of approximately $413 billion reflecting a deficit in the neighborhood of $50 billion, compared to $68 billion in FY 1976. It is likely that fiscal policy will remain stimulative over the coming year and such stimulation may raise questions of the demand pressures which might result from large deficit spending as well as the cost pressures which such spending may engender within the economy. Perhaps of equal importance will be the necessary response of the monetary authorities to such a continuing deficit level. While the Federal Reserve in its handling of monetary policy can in effect make the Treasury meet the test of the market place, there may develop new pressure for higher rates if basic competition for funds increases over the coming year.

We should note that fiscal policy is not static, even though the general dimensions of the budget have been set for the coming year. The possibilities of new initiatives to alleviate the unemployment problems of the nation could conceivably bring even greater spending than is contemplated in the budget document. Some of the questions over the developing economic situation and possible need for further efforts to reduce unemployment might engender actions breeding a stimulus to the economy which could re-ignite inflationary pressures.

The large deficits of FY 1976 and 1977 will require additional major financing efforts by the Treasury over the next 12 months. While the Treasury has been quite successful in raising the large sums needed to meet refinancing and new financing needs in the past nine months, such ease of financing has been facilitated by the lack of pressure on credit markets from other borrowers, especially from companies who might have been competing for funds if business short-term credit demands had accelerated. Over the remaining months of 1976 and into 1977 the Treasury may not find such an agreeable market or such a dominant position as primary borrower.

In the Treasury marketing of new debt, we should note that some of the flexibility for longer-term issues authorized by Congress has been used already in the 1976 financings so that a heavy portion of Treasury issues in coming months are likely to be in the bill and note maturity sectors of the market. It is precisely these same areas and the impact from competition in these areas which are likely to create the greatest pressure on interest rates in the coming year.

With regard to monetary policy, there are several important factors which seem critical to the Federal Reserve's deliberations over the coming months. First, we should distinguish between the policy impacts on current market environments and the time dimension of policy action which impacts upon the economy over a longer span of perhaps a year to 18 months. If monetary policy were to have an exclusive short-run focus, then accommodations to the recent softness in the economy, the stagnation of business loans and the lack of pressure on market interest rates would argue for further stability or even a slight easing of policy. If the Federal Reserve were to plan its monetary policy strategy for only a long-run impact, then actions may soon be required to resist continued growth of the money supply at levels exceeding the long-run needs of the economy. In other words, if the Federal Reserve is to make a significant contribution to the long-run stability of the economy, it will need to keep a weather eye on the total growth of the money supply needed for real economic advancement in 1977 and 1978.

The problem of policy focus encompasses both time horizons and the targets for measurement of policy. If policy is to be measured only by the rate of growth of monetary aggregates, this will mean a long-term horizon for policy action and less attention to the short-run deviations or sags in the rate of growth. On the other hand, if expectations in the market place, rates of interest being paid, and temporarily disruptive moves in financial markets are to be important in the monetary policy of the nation then monetary aggregates will have to be stressed only as long-term targets rather than short-run guides. Such a policy measurement prescription is not totally inconsistent because policy can accommodate short-run deviations and yet hold to the longer-run money supply objective. In the coming months, of course, the critical features of the growth and development of the recovery and the expectations in the market place which might ramify into greater or lesser spending by consumers or business as well as the extremely important questions concerning business loan demand will all have a major airing in monetary policy discussions. International monetary pressures may create unwanted diversions which monetary policy may be called upon to moderate but later speakers will address this problem so no further comment seems needed at this point.

Behind these more visible elements must be continuing attention to the problems of unemployment and inflation. While monetary policy may contribute through stability or even restraint on the rates of growth in money supply to an improved inflationary position, the nation's central bank can do little more directly toward improving unemployment without running severe risks of increased inflationary pressures.

If the economy continues to develop in its present pattern and the rate of capital spending does develop into a strong support to the economy, then higher levels of business activity should reduce unemployment--providing labor force gains subside toward more normal historical levels. No one can be certain of the unemployment pattern of the months and years ahead, but it seems evident that the labor force has been growing recently at a pace faster than the economy is providing new jobs.

It will be the job of the central bank to hew that fine line of sufficient stimulation to encourage further growth in retail and business sales and support capital expansion and yet not provide excessive reserves to the banking system or liquidity to the nation which might generate a new round of inflationary price increases.

Our success in achieving a balanced monetary policy will only be evident over a considerable period of time. We should not become impatient with the rate of progress given the years in which inflation has built up in this nation. It would seem to me that to correct a ten-year development of the inflationary problem in a period of three years would be a reasonable objective of this nation. On the other hand, one cannot be sanguine about the hardships of the unemployed, and if measures can be taken to alleviate that problem, such actions should be considered carefully by the Government. In conclusion, the primary contribution of the Federal Reserve, both to a balanced recovery and lower levels of unemployment, is a monetary policy which encourages reduced inflationary attitudes and pressures.

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