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THE FINANCIAL BATTLE LINE

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In 1977 the economy successfully waged the battle for higher production, employment, and incomes. The 5-3/4 percent growth of real output during the year provided for a decline of more than one percentage point in the unemployment rate, despite rapid growth in the labor force. In contrast, the fight against inflation was at best a draw, as the increase in prices for the year remained around 6 percent--the underlying rate for some time now. The rapid economic growth in 1977 was accompanied by record increases in credit flows relative to economic activity and basic money supply rose at a faster pace. Thus, the ammunition of inflation was stockpiled during the year.

Today I would like to discuss with you the main domestic financial forces operating in 1977 and those likely this year. In addition, I will examine the setbacks in the international financial arena over the past year, when a sharply widening trade deficit put the exchange value of the dollar under strong downward pressure. Finally, I would like to highlight some of the potential tensions among the economic goals of our nation.

As you will see, I perceive the possibility of conflict among the objectives themselves. In fact, I chose the metaphor "The Financial Battle Line" as the title of my remarks to convey this idea. For if financial forces are directed mainly toward attaining only one of the nation's economic objectives, other goals may be imperiled or even inadvertently sacrificed. The problem of potentially conflicting objectives arises because all aspects of the economy are interconnected and an action in one area may cause an untoward reaction in another. But if disagreements exist about the relative importance of the various objectives, the very possibility of tradeoffs between objectives can lead to disagreements regarding appropriate tactics. And differences of opinion about the strategy for economic policies become political conflicts. The Federal Reserve, with the independent responsibility for establishing monetary policy and influencing financial conditions, is inevitably in the center of the fray, if not point man in the forward patrol.

To some extent, differences in views surfaced in 1977, despite the excellent record of economic growth, as the Federal Reserve took some policy actions designed to restrain growth in the monetary aggregates in an environment of rapid growth in credit flows. Indeed, in 1977, total credit demands of nonfinancial sectors, led by households and businesses, climbed to a record 18 percent of GNP. Both mortgage and consumer borrowing were at a record pace, with mortgages accounting for the lion's share. Besides helping to finance record sales of new and existing homes, mortgage funds were indirectly used for non-housing related purposes, as households withdrew a portion of their accumulated equity in dwellings. Active demands for consumer credit accompanied substantial sales of new automobiles and other durable goods.

On the business side, the need for financing became more pressing in 1977 as the step-up in capital outlays outstripped growth of internally generated funds. The heightened business credit demand was reflected in a greater reliance on short- and intermediate-term borrowing from banks and finance companies, on the one hand, and in greater mortgage borrowing to finance the expansion of multi-family and commercial building activities on the other.

In contrast, the urgency for equity and long-term debt financing was reduced following the restructuring and strengthening of balance sheets achieved during 1975 and 1976, but the expansion in short- and intermediate-term corporate borrowing was accompanied by further accumulation of financial assets. In general, it would appear that corporations in the aggregate last year acted to retain their strengthened balance sheets.

In the public sector, State and local governments issued securities at a record pace, while simultaneously running large operating surpluses. Together with the large volume of advance refundings, this sector thus made sizable acquisitions of financial assets, especially U.S. Government securities. Indeed, in 1977, State and local governments acquired an amount equal to about 25 percent of total new Treasury borrowing from the public. While deficit financing of the Federal Government declined for the second year in a row, it still remained sizable.

Supplies of credit from more traditional sources were ample in 1977. While credit supplies by households and U.S. Government-related sources increased, lending by private financial institutions, as usual, accounted for three-fourths of the total provided to non-financial groups. At commercial banks total loans and investments picked up substantially. Strength was evident in all major loan categories, with business loans rebounding briskly from the depressed 1975-76 levels. With the surge in loans, banks increased their reliance on large time deposits and other borrowings, particularly in the fourth quarter, when inflows of deposits subject to Regulation Q ceilings slowed. At thrift institutions, continued high mortgage demands were accommodated by substantial deposit inflows, although these institutions increasingly turned to larger non-deposit sources of funds near year-end and into 1978 when deposit inflows slackened.

While credit supplies were adequate to finance the continued economic expansion last year, the higher demands bid up the costs of credit. The surge in short-term credit demands, together with the Federal Reserve's resistance to excessive growth in the monetary aggregates, were associated with increases in short-term interest rates of about two percentage points over the year. However, rates on longer-term corporate and Treasury securities rose by substantially less while rates on municipal bonds edged slightly downward, reflecting heavy institutional and individual demand. This demand arose from improved profit performance of banks and fire and casualty insurance companies and from the effects of rising marginal tax rates for individuals.

Thus far in 1978 uncertainty in foreign exchange markets, the continuing coal strike, and unusually severe weather have muddied the economic battlefield obscuring the underlying currents. In terms of real activity, much of the recent disappointing statistics in the non-financial area--such as reports of declines in retail sales, industrial production, and housing starts--were probably related to adverse weather and strikes. On the brighter side, employment and earnings gains have remained quite strong. In addition, recent trends of equipment orders and inventories suggest underlying strength in business investment spending.

On the financial side, total flows of credit in early 1978 appear to be remaining at about the average of last year's pace. While short-term rates moved up a notch in January, as the discount rate and Federal funds rate were raised for international purposes, they have since remained unchanged or edged slightly lower. Long-term rates, including mortgage rates, have generally increased a little, reflecting heavy Federal borrowing and the continued slowing of funds into deposits at thrift institutions. Stock prices began to decline in early January apparently in response to uncertainty about the dollar and U.S. policy responses.

International factors played an increasingly important role in the development of U.S. economic and financial conditions in 1977. The U.S. trade deficit widened from $9 billion in 1976 to an unprecedented $31 billion in 1977. The expectation that the deficit might continue at that level through 1978 became a major source of pressure on international financial markets and the foreign exchange value of the dollar.

The enlarged trade deficit reflected several developments. Imports grew rapidly during 1977 in association with the further strong domestic economic growth. Oil was of considerable importance in 1977, accounting for about one-third of the increase in imports as oil consumption rose and stocks were built to record levels, while domestic oil production stayed flat. With the volume of oil imports nearly twice as high as five years ago and prices five times as high, oil imports have soared from less than $5 billion in 1972 to $45 billion in 1977.

The expansion of non-oil imports in 1977 was also of major significance and was spread over most commodity groupings. Increases in certain categories of industrial materials, like steel, and consumer goods, such as color television sets, reflected more aggressive selling efforts by foreign producers who were facing slack demand at home. This gave rise to protectionist pressure in the U.S. which threatened our relatively free trading system.

While imports rose strongly in 1977, exports were only slightly above their 1976 level, with most of the gain accounted for by price increases. The lackluster performance of exports reflected the substantially slowed economic growth of our major industrial trading partners. The rate of expansion of activity in Japan and Germany last year was about one-third of the rate in 1976. U.S. exports to these two countries rose only slightly last year. With a more rapid expansion on the import side, our trade deficit with Germany widened to more than $1 billion, and with Japan to more than $8 billion. This exceptionally large deficit with Japan led to negotiations which culminated in an agreement by the Japanese to take steps to stimulate their imports from the United States and other countries.

Private international capital transactions recorded by U.S. banks, securities dealers, and corporations continued to show a net outflow in 1977, though down somewhat from the year before. The decline in the net outflow reflected a slower growth in international credit demand and a greater reliance by U.S. banks' branches abroad on funds raised directly in foreign money markets. However, unrecorded private capital flows, which enter in the residual item in our international accounts, showed a substantially larger net outflow in 1977, particularly late in the year when speculation against the dollar increased. Some of this may have reflected changes in international payments patterns--the leads and lags effect.

The net outflow of funds due to the trade deficit and private capital transactions was about matched by a large increase in foreign official purchases of securities in the United States, principally obligations of the U.S. Treasury. About half of this increase reflected the rebuilding of reserve holdings by the United Kingdom and Italy. Other countries adding to their dollar assets in the United States included Germany, Japan, and Switzerland, all of whom engaged in large scale exchange market intervention purchases of dollars late in the year.

The dollar came under strong downward pressure in foreign exchange markets in 1977, primarily in the fourth quarter. It declined over the year by 7 percent against a weighted average of ten major foreign currencies, including depreciations of about 20 percent against both the yen and the Swiss franc, and more than 10 percent against the mark. This downward pressure has continued during the first three months of this year. Pressure on the dollar emerged from the growing concern over the rapid expansion of U.S. oil imports and the trade deficit, from uncertainty about U.S. policy toward the dollar's exchange rate and from the reappearance of stronger inflationary trends in the U.S.

The behavior of exchange markets has at times evidenced very large rate fluctuations, unusually wide spreads between buying and selling rates, and even one-sided markets. It has been the policy of the United States to intervene in exchange markets to an extent necessary to counter such disorder. In recent months the Federal Reserve in cooperation with the U.S. Treasury has drawn on our swap lines with foreign central banks to obtain sizable amounts of foreign currency with which to intervene in the exchange markets.

In addition to the inflationary impact of the deteriorating dollar exchange rate, the degree of fluctuation in that rate has created a sizable uncertainty in business and political expectations. In making plans concerning long-term sales contracts and investments, firms must increasingly be concerned with protecting against foreign exchange losses. Similarly, the economic and political uncertainties are exacerbated by potential reactions of foreign government and business decisions, especially on oil prices. Even the U.S. consumer is faced with a new uncertainty, impacting upon disposable income.

Down the road, the dollar's depreciation may prove to have been excessive in view of the underlying productivity of our economy and our relatively favorable growth, compared with many other countries. There has been no fundamental deterioration in our international competitive position. In fact, the recent depreciation of the dollar has improved the competitiveness of U.S. exports and will help to reduce the trade deficit in the future. Other factors too may help stem further deterioration in the trade deficit. A pickup in foreign economic expansion would stimulate U.S. exports and the growth in value of oil imports could moderate somewhat because the OPEC countries may continue present oil prices in reaction to the present surplus and because the Alaskan oil production has come on full stream.

In order to assess the prospects for the economy in 1978 and beyond one needs to step back from the details of the recent experience and survey the larger picture with all its interconnecting elements, including the role of governmental policies. From this vantage point, what comes into clearer focus is the problem of conflicting objectives that I alluded to earlier.

Domestic and international objectives are clearly intertwined. Any major depreciation of the dollar, while tending over time to reduce the trade deficit, adds to inflationary pressures fairly promptly. Imports become more expensive and domestic competitors find it easier to raise prices. If financial conditions in the U.S. were to tighten, capital might be attracted from abroad and the dollar would strengthen, but higher interest rates could also diminish domestic investment spending and run the risk of retarding the recovery. Conversely, easier financial conditions might provide some short-term impetus to the U.S. economic expansion, but could worsen inflation, exacerbate the trade deficit, and weaken the dollar.

Over the next year the actual resolution of the tension between domestic and international objectives will depend importantly upon governmental policies. Minimum wage hikes and Social Security tax raises have already begun to push up wages and prices. We will have to wait and see the Congressional outcome of the Administration's tax and energy proposals. As for monetary policy, the Federal Reserve hears contradictory views regarding both technical questions and policy expansiveness. On the technical level, for example, monetarists advise the Federal Reserve to concentrate upon monetary aggregates as the intermediate guide to monetary policy. Keynesians, on the other hand, suggest setting such policy in terms of the level of a short-term interest rate, like the Federal funds rate, judged to be consistent with economic goals. This Keynesian argument has been made more forcefully since money demand apparently became less stable.

Because economics is an inexact science, the evidence on such issues is rarely decisive. Federal Reserve operations actually include a role for both monetary aggregates and the funds rate. Rather than satisfying either camp, however, Federal Reserve policy has straddled both positions and thus has become the target of criticism from both.

While not a shooting war presently, this conflict could become a major battle in 1978, particularly if the pace of the expansion produces intensified demands for money and credit. The substantial needs of the U.S. Treasury for funds on top of strong private credit demands could put further upward pressure on interest rates. At the same time, the public's demands for money for transactions purposes could be generating growth of money at a fast clip. Such developments would set the stage for renewed debate as to whether the Federal Reserve should make reserve provision more accommodative to resist upward interest rate pressure or less accommodative to resist faster M_1 growth.

A more widely contended issue regarding monetary policy concerns the Federal Reserve's relative emphasis on fighting inflation versus unemployment. The Federal Reserve has argued that exclusively stressing either goal endangers the attainment of the other. Our prudent course of promoting a solid recovery while attempting to restrain further inflationary pressures has not met with complete success for either nor full agreement among the public.

There is a strong case for adhering to this moderate course. While present unemployment can fall further without making labor markets overly tight, nonetheless at some point remaining unemployment will be largely structural, impervious to policies affecting aggregate demand. Even current inflation is, over the short run, stubbornly unresponsive to changes in aggregate demand. Monetary policy can only provide an environment conducive to the gradual unwinding of these problems. A more rapid solution probably awaits innovative micro-oriented initiatives.

In the meantime, the Federal Reserve has to resist a built-in bias in most of our governmental structure which leads to political pressure for a more expansionary monetary policy. Congress wisely established an independent Federal Reserve to provide a counter-balance to the possible temptation to undertake short-term monetary policies that are inappropriate over the long run. The Federal Reserve is uniquely capable of representing the longer-term public interest, while resisting short-term expedients. To some degree, some tension between an independent Federal Reserve and other governmental bodies is inevitable. It is a part of the over-all system of checks and balances incorporated into our governmental structure which has served the nation well.

Returning to our battlefield analogies, there are some who believe that the Federal Reserve has been forced into a purely defensive position like drawing its wagons into the traditional circle, while its policies are being out-flanked by both the internal inflationary moves of government and the external mercantilist tactics of competitors abroad. Some even see a threat of insidious infiltration in the rising interdependence of nations and their economic policies, which will be difficult to counter if the Federal Reserve adopts a provincial strategy. And finally, some see the Federal Reserve out-gunned by the sophisticated forces of credit mobility and rate competition in a world of steadily tighter policy and growth interlocks.

If our defenses in economic and financial policy, theory, and practice were outmoded like the arrows and lances of tribal warfare while the war is fought with jets and cruise missiles, the problems would be manifest. But the Federal Reserve has its own arsenal of modern weaponry. It can reinforce its lines of defense with strategic stockpiles of swap agreements, probing repurchase and sales-purchase transactions, a sophisticated intelligence gathering network, and a response-oriented policy environment. Thus, even though some skirmishes have gone badly, it is far from clear that the war is lost. Backed by a strong economy, an independent and free enterprise-oriented populace, and an innovative business leadership, the U.S. has the staying power for eventual victory.

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