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ECONOMIC DEVELOPMENTS

Remarks of

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I have returned to Los Angeles as a semi-native. When I moved here in the Army 23 years ago, I had my first contact with the savings and loan industry. I made an initial deposit or share purchase in a local savings and loan in 1942.

Last week I checked to see what had happened to your industry in the interim. I found that California savings and loan institutions had $300 million in shares outstanding in 1942. Now they have over $20 billion. That is a growth of nearly 7,000 per cent. Nationally your industry has grown from under $5 billion to over $106 billion, or by 2,200 per cent in the same 23 years.

Growth on this scale demonstrates the excellent results obtained through Government and industry cooperation. Without Federal savings and loan insurance, the story would be very different. When they operated completely on their own, our banking and thrift institutions suffered from a long record of losses, instability, and runs. Because even the best felt repercussions from the troubles of the worst, there is now a nearly unanimous agreement that Government support, cooperation, and regulation are necessary.

The savings and loan industry is a dramatic example of growth. So is our overall economy. Every day, we set new records of output, wealth, and well-being. Our economy has been expanding steadily for 56 months, by far the longest peacetime expansion in our history.

The record of this expansion is striking. Since February 1961--

Gross national product is up over $173 billion.

The Federal Reserve index of industrial production has increased 38 per cent.

Families have $117 billion extra in income to spend or save.

Corporation profits are more than $21 billion higher.

There are 5-1/2 million more people at work.

Unemployment has fallen from 6.9 to 4.4 per cent.

Compared to the previous peak in May 1960--

Deposits in commercial banks have risen by 52 per cent.

Savings in your savings and loan have gone up by 88 per cent.

Causes of Downturns

While we all rejoice in this record, a great deal of worry is evident. Everywhere I go people ask one or the other of these questions:

1. Hasn't the expansion gone on too long; doesn't it have to end soon?

2. Isn't a record expansion bound to lead to overheating and inflation?

The simple answer to both is <u>no</u>. Let me use the remainder of my time to explain why caution and understanding are necessary but fear is not.

First I would like to point out that many economists--myself included--have avoided use of the term "business cycle" for over 20 years. "Cycle" is a poor term because for many people it connotes an inevitable sequence of events. What cycles up must cycle down. This is not the lesson of history. Contractions or depressions don't just occur. They are caused and can be explained.

While past expansions have ended for a wide variety of reasons, their causes can be grouped under four major headings.

a) War, international crises or shortages, or similar outside forces have caused the economy to operate for a time under forced draft. Later this extra demand has fallen off.

b) Governmental operations. The impact on the economy of governmental expenditures and taxes has been sharply reversed by governmental action or, as likely, inaction. This has occurred either through a change in fiscal policy or a failure to change it, as when so-called "fiscal drag" went unrecognized and unheeded.

c) Credit. The banks or the monetary authority have brought about a slowdown in the expansion or a contraction in the supply of credit.

d) Over-investment. Production of housing, of inventories, or other types of investment has exceeded a level sustainable by the growth in final demand.

The New Economics

Better understanding of why past expansions have ended has led to the concepts of the New Economics. What does this term mean? I think it contains three related ideas:

First, agreement that a continuing expansion of income, jobs, and welfare and a minimal price rise is a possible and proper national goal.

Secondly, recognition that reaching our goal requires understanding and deliberate action in monetary, fiscal, and wage-price fields.

And, thirdly, widespread acceptance by business and political leaders, and by the press and public that the nation's requirements must be considered in making price and wage decisions and that monetary and fiscal policy should be used more positively. Most significantly, the ideas taught by economists for the past 25 years have gained wider acceptance. Maintaining progress may require a deliberate use of the Federal budget and of credit to add to or subtract from total demand. Government action should be deflationary when total demands are threatening to outrun available supplies. It should add to income when other demands fall short of our growth potential.

The New Economics puts a heavy burden on gentlemen such as you, who are recognized as experts in the areas of finance and budgets and do so much to help form public opinion, to understand and explain current economic events. As business leaders, you are well aware of major community needs such as those for schools, parks, health, and national defense which can only be met on a governmental basis. As economic observers, you see immediately the impact on your savings flows and mortgage demands when the Government shifts from a policy of expanding to one of contracting overall demand.

Monetary Policy

Relative price stability has characterized our present expansion. Now, however, the backlog of unemployed resources has diminished. The gap between production and potential output has shrunk. Clearly price increases are more likely. If total demand rises at a much faster rate than supply, inflation will be an immediate danger.

These facts have led to a widespread debate on the proper stance for monetary policy. I might comment briefly on this debate. In doing so, I want to make two things clear. Our economy changes rapidly. A great advantage of monetary policy is that it can react and shift with the economy. A correct policy today might not be a proper one a month, or even two weeks, from now.

Secondly, as you all recognize, the formation of monetary policy is complex. Final decisions by the 12-man Federal Open Market Committee are made in the context of changing credit needs and the fiscal plans and requirements of the rest of the Government. Obviously any information you might glean today about my own views in the transient circumstances of the day may have little relation to any future decisions of the Committee as they are molded in the crucible of public and private debates.

Criticism of Current Policy

Critics of current monetary policy range from those who feel that recent moderate firmness is far too easy to those who feel it is much too tight.

Criticism can be grouped roughly under six headings.

1. Some, as represented by certain European central bankers, believe that adjustment in our critical balance of payments situation can be brought about only by action so restrictive as to risk deflation. To contract demand, we should raise interest rates. Depressed countries import less and may export more.

2. Others fear the future because of Viet Nam. They judge that the amounts which rumors say we might spend on the military could not be added to other demands without inflation. As an offset, civilian purchases of houses and similar goods should be contracted by a tighter monetary policy.

3. Some believe that any expansion must be paid for by a later contraction. They neglect the opportunities for growth. Based on a false analogy that the higher you rise the farther you must fall, they would like to see the fall start from our current rather than some future higher level.

4. Others feel the rate of expansion must be slowed because it contains, or may lead to, serious distortions that would require a depression to correct. Two different types of reasoning end up believing in tighter policies. Some maintain that continuing credit expansion at current rates is bound to end in trouble. Credit will either deteriorate in quality, or it will lead to too much spending with inflationary consequences. Others take almost the opposite point of view. They feel credit must be contracted to hold production at sustainable levels. Continued expansion at current rates means to them that some areas will exhaust demand and be left with unsaleable backlogs of goods. Such imbalances will lead to a depression.

5. Still others hold that money currently is too tight, not too easy. They argue that our excellent record has been possible only because sufficient money and credit have been available at reasonable rates. Some credit has come from additional reserves, but much has come from tapping pools of liquidity left from previous periods. They feel that recent interest rate increases mark the exhausion of this prior liquidity. Unless reserves are made available more rapidly, the supply of credit will be insufficient to sustain normal growth. Interest rates will rise. Demand will contract. We will experience another recession.

6. Finally, some believe that monetary policy has been too firm throughout the expansion. The rate of growth would have been greater with cheaper money. Continuation of the expansion can be assured only by much cheaper interest rates and the availability of far more credit.

Reject Out of Hand

I think we can reject the first three views out of hand. I believe, as do most people in Washington, that adjustment of our balance of payments is an immediate serious problem. President Johnson has stated the firm Administration goal of bringing our balance to equilibrium. However, I judge that most officials reject the depression road as an improper path to equilibrium. Certainly I do.

Every time I hear someone urge deflation, I am reminded of Lamb's famous story of the first roast pork. You remember the tale of the tribe whose hut burned with a pig inside. In clearing the debris, they discovered succulent roast pork. For years thereafter they burned another hut every time they wanted roast pig. Only gradually did they learn that you could cook more efficiently and with less economic waste.

I see our payments problem in this same way. Our foreign sales are less than 6 per cent of our total income. It is far more efficient to deal with a lack of foreign balance directly, as we have done through the interest equalization tax and the voluntary foreign credit restraint program, than through throwing the entire economy into a depression.

Similarly it would be wrong for the Government to base its monetary policy on Viet Nam rumors instead of on its own best facts and estimates. The Vice President, Secretary Fowler, and Chairman Ackley have all said that probable increases in our defense expenditures have been greatly exaggerated. While these added expenses are unfortunate because of the sacrifices involved as well as the necessary postponement of tax cuts and more desirable Government spending, present plans for additional military spending do not require a basic shift in policy.

In fact, the best available spending and tax estimates show that for this fiscal year, allowing for the announced increases for Viet Nam, we may already be feeling the maximum expansionary pressures in relation to supply to be expected from fiscal changes.

Similarly, the idea that cycles are necessary and that expansions must lead to proportionate contractions has no basis in fact. Policy based on such beliefs has led to disastrous events in the past. We must believe that we do learn from past mistakes. We need not repeat them.

Supply and Demand

In analyzing the other three contentions I named, we must examine the present as well as expected relationships of supply and demand and their impacts on wages and prices.

The current expansion has brought our employment and operating rates closer to desirable levels than they have been in nearly a decade. What about the future? While there is not yet an official forecast for next year, the consensus of business and university economists is that growth will continue at approximately the same rate as in recent months. If so, demand will expand at about the same pace as potential output. Rates of unemployment and capacity utilization will change only slightly from the present.

These rates do not threaten inflation. Unemployment in September was 4.4 per cent. In many categories, there are still more people seeking work than in 1953 and 1956. Although a few skills are in short supply, no major labor market reported an overall shortage. Past experience indicates that specific shortages can be met rather readily through training and upgrading.

A similar situation exists with respect to our overall use of plant and equipment. Few serious bottlenecks have appeared. While we lack good information on capacity, utilization appears to have risen steadily from a low of around 78 per cent in 1961 to the vicinity of 90 to 91 per cent in recent months. This is still somewhat below the preferred rate for peak efficiency. However, since it is an average, some industries--mainly in durable goods--are operating above their preferred levels.

Prices and Wages

We know that absence of generally excessive demand is, unfortunately, no guarantee of price stability. There can be a cost-push from pricing or wage-setting. Does such a push seem likely?

Industrial prices are about 1.4 per cent higher than at the start of 1964. This is more than the total amount of increase for the entire period since 1959. Until the recent price flurries, these prices had moved up and down, but had no upward trend. We would all hope that the highly successful six-year record could be maintained.

The wage situation appears promising. Although some increases, particularly in construction, far exceed the guidelines, in manufacturing unit wage costs have decreased in the past two years. The rise in productivity has outpaced that in money wages. Furthermore the calendar of labor negotiations for the coming nine months shows few major problems.

The most difficult areas are nonferrous metals and machinery. These are basic industries in which prices have been rising. Their demand has reached or exceeded capacity. Prices and profits have expanded, but the fact that capacity is rising also may moderate further movements. With these and other minor exceptions, existing cost increases seem selective rather than pervasive. They give no indication of a cumulative interaction of rising prices and costs. Business and labor statesmanship appears to be better than at times in the past. While a few giant firms could cause prices to rise regardless of any justification from the basic supply and demand picture, such action appears less likely than in the 1950's.

The price-wage situation does not add up to signs of overheating. While tighter credit could be forced by the irresponsible action of a few in key industrial firms, such prospects appear less probable than in the last decade. Lacking such cost-push, the supply and demand situation shows little justification for tighter credit.

The Supply and Demand for Credit

Another debate concerns the amount of credit made available to the productive sectors over the last year and a half. A rate of increase close to 9 per cent in bank loans and investments, and an almost 7 per cent rise in liquid assets--the deposits of banks, savings and loans, and mutual savings banks plus short-term Treasury securities--exceeds the growth in GNP. This expansion has been accompanied by stable mortgage interest rates, a rise of 14 per cent or 50 basis points in the bill rate, and a 20 basis point increase in corporate bond yields.

Some feel that such a growth in credit cannot be maintained. They believe that an expansion accompanied by this much additional debt must contain within it the seeds of its own destruction. Others argue that such a view of the economy is, like the belief in inevitable cycles, simply incorrect. Since the establishment of the Federal Reserve we have had no expansion that ended because of too rapid a rise in credit.

On the opposite side, many critics believe that too many expansions have ended because of a failure of credit to expand. They fear that recent events herald a similar prospect. While credit expanded at a 9 per cent annual rate, the money supply grew only at 4 per cent, and nonborrowed reserves at less than 3-1/2. They see the recent interest rate movements as a reflection of a lack of liquidity. They fear a recurrence of prior periods in which they believe growth was reduced by too little credit.

The optimists for next year base their predicted gains on a continued expansion of plant, equipment, and inventories. Such expectations of high investment assume that credit will be available and at costs similar to this year. If credit were to tighten more and interest rates were to continue their rise, the present optimistic predictions would have to be revised downward. This would concern most people greatly. It would be welcomed, however, by those who believe that one should always stop expansions when the first signs appear of possible price rises.

Conclusion

In concluding, I would like to return to the two basic questions asked at the start. I think it is clear that nothing inherent in the length of this expansion requires either a downturn or an inflation. The proper uses of fiscal and monetary policy have maintained an excellent economy. We have had growth without major distortions or price increases.

The continuation of our current growth rate is, however, far from certain or automatic. It is no more necessary than is a contraction. If excesses develop; if prices and wages chase each other; if demand falls in too many specific sectors; if we make poor policy choices, the expansion will be slowed or halted.

To maintain growth and prosperity, it is vital that we all have a clear understanding of our current economic situation and the types of policies which have made this expansion possible. The American people deserve and want to support the best possible policy. For this they need proper knowledge.

Our economy is dynamic. Progress depends on millions of independent decisions. Our excellent record of the past four and a half years is based on an environment of aid and cooperation which has made it possible for our economy to develop its full potential.

We must all work to maintain our present momentum.