FOR RELEASE ON DELIVERY
FRIDAY, FEBRUARY 14, 1975
12:00 NOON C.S.T. (1:00 p.m. E.S.T.)

OIL AND FINANCE

Public Policy for the Economy

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The Richard J. Gonzalez Lecture Series

at the

University of Texas at Austin
Austin, Texas

February 14, 1975

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Public Policy for the Economy

Beyond a doubt the primary question for Washington and the nation over the next few weeks must be the selection of appropriate public policies concerning the economic and financial actions to be initiated by Congress, the Administration, and the federal agencies. These decisions will greatly affect the near-term economic future of the nation and have potentially large effects on the longer-term prospects. In addition, the implications of these decisions may have far-reaching impacts upon the international position of our currency, and even the political power of our nation. To say the least, these public policy decisions may be of considerable importance both for 1975 and for years to come.

The background to these decisions includes a ravaging inflation of 11 per cent which has induced a deepening recession evidenced by large declines in industrial production, and an unemployment rate above eight per cent. The inflation was born chiefly of our excessive government spending of the 1960's, nurtured by too rapid credit creation and monetization of the government deficits, and then sustained by both wage pressures to maintain workers' real incomes and the distortions of the wage-price control program. These fundamental domestic factors were further aggravated by the devaluations of our currency and the resulting pressures of excess demand for U.S. products as well as the poor grain crops which added foreign pressure on U.S. agricultural prices. Finally, of course, the inflation was sharply accelerated by the cost pressures originating in the startling oil price increases.

The recession, too, had its roots in the imbalances of a long period of excesses in economic and financial speculation and in the uncertainties and instabilities of currency depreciation. But the principal triggering factor accelerating the downturn was the rapid inflationary spiral of early 1974. A contributing factor was the unavoidable countervailing pressure from a more restrictive monetary policy. Both contributed to the decline in consumer demand as inflation reduced discretionary incomes, while monetary policy restricted credit availability with further impetus to the rising cost of borrowing. With the declines in consumer demand, business inventories became burdensome and production was curtailed, forcing cutbacks in employment.

To cushion the developing recession, monetary policy began easing in late summer and by February had reduced short-term interest rates by 50 per cent. Overt central bank actions have included a combination of two reductions in reserve requirements releasing about $2 billion in reserves and three separate reductions in the discount rate which brought that rate from 8 per cent to 6-3/4 per cent. Perhaps more importantly, the open market operations of the central bank were used to feed additional reserves to the banking system, causing a sharp rise in non-borrowed reserves.

Central bank actions to increase credit availability have enabled banks to repay virtually all borrowings from the Federal Reserve as well as to add otherwise to their liquidity. Banks have appeared to be reluctant to seek new borrowers perhaps because of a desire for improved capital and liquidity. Prime rates have come down quite slowly as banks sought some measure of relief from the intense credit demands. Whatever the reason, and one could cite also profit margin and liquidity considerations and even locked-in long maturity CD costs, the slow decline in prime rates has shifted the pressure for loans to commercial paper and bank loans have declined.

In addition, there has been no major move by consumers or businessmen to actively seek to borrow the newly-available funds. Consumers are still less than confident of their economic future and being fearful of job security have been slow to make major purchases requiring credit. Businessmen similarly lack confidence and are looking for increases in final demand before committing to new capital endeavors. Moreover, many businesses are in the midst of liquidating inventories and until this process moves further so that stocks are in better balance with sales, businesses are likely to hold down their bank credit demands. Consequently, the newly-created reserves have been largely going into debt repayment rather than increasing the nation's money supply.

By early 1975 with cost pressures still pushing prices upward--albeit more slowly--the nation had moved rapidly into the deepest recession of the postwar period. As layoffs increased, consumer confidence and purchasing declined causing even further production curtailments. Even though unemployment has risen sharply and some secondary declines are taking place, it is not too late to break this spiral and avoid a cumulative downturn of significant proportions.

Public policy is therefore faced with the urgent need for prompt and sizable stimulation of the economy and decisions must be made as to the means, timing, and degree of stimulation. Tax cuts to reinvigorate consumer spending and increased investment tax credits to spur corporate capital spending are under active consideration and presumably some actions will be taken. Increased unemployment compensation benefits and a special jobs program are already in place, and with the other actions proposed, will cause a record deficit in our Federal Government budget. To the extent that the primary stimulus from these actions will be felt before mid-year, they will have a major beneficial effect toward economic recovery but the longer the delay the more the effect may be counterproductive by adding stimulation after recovery has commenced.

Similarly, actions to ease monetary policy beyond those already in place must be approached with great care to insure that the primary impact occurs in 1975. Given the long lag times between credit policy actions and their effect upon the real economy, the central bank has only a limited amount of policy flexibility.

Overstimulation could lay the groundwork for a new inflationary surge in 1976, but understimulation could mean a deeper and longer recession. It is indeed a fine line of monetary policy determination, and one which could be pushed out of alignment by excessive stimulation through fiscal policy or budget deficit financing.

Great care must also be taken to insure, as best we are able within the complex of potentially conflicting objectives, that our international position is not damaged by our actions to stimulate recovery. Our domestic problems of a slow consumer demand, rising inventories, reduced production, and increased unemployment, will be attacked on a multiple front of tax cuts, tax stimulation, increased credit supplies, and a job program. But we and other nations have done little to contain our international problems especially the financing burden of oil-consuming countries, the uncertainties generated by rising external debts, and the instabilities inherent in the wide fluctuations of exchange rates. These problems are presently reduced to second priority consideration by the pressures to contain recession and stimulate recovery. But over a longer time span, such problems have an important bearing upon the possibilities of re-establishing economic equilibrium both in the United States and elsewhere. Unless we can reduce our dependence upon foreign sources of energy, we will be constantly in fear of a new embargo or another round of price inflation. In fact even to pay the current costs of oil imports into the United States and other nations, will require deficit financing on a massive scale and the transfer of financial instruments to the oil-producing nations. While these transfers do not mean a lower standard of living, unless the funds are used to purchase real goods, they nevertheless constitute a part of the large overhang of dollars presently flooding the markets of the world.

It is true that the United States is more nearly self-sufficient in energy than most other industrial nations, and the impact of the oil import cost is therefore somewhat less. However, the dollar is used by most nations to pay for their oil imports and thus to a considerable extent the impact of oil payments for most nations falls upon the U. S. currency. This impact, and the relatively lower interest rates in the U.S., have begun to show themselves in a deterioration of the exchange rate of the dollar which has necessitated supporting intervention by U.S. and foreign central banks. These pressures on the dollar have also been evident in our deteriorating balance of payments position. Our international problems may not take top priority in the near-term, while we endeavor to contain and reverse the domestic recession, but they will restrict our actions since our domestic solutions to counter the recession in the short-run may have longer range implications aggravating our international position. We will need to keep a careful eye upon both short- and long-range impacts as we structure our short-run policy responses. We can already see the deleterious and sizable affect on capital flows of the decline in short-term interest rates to levels below those in primary financial markets abroad. There will be other similar problems if stimulation is accomplished largely through monetary ease rather than fiscal or budget measures.

The central bank has been trying to achieve a more rapid expansion in the nations' money supply. The fact that we have not yet accomplished this increase in the narrowly defined money supply (M_1), in no way suggests that the Federal Reserve is insensitive to the hardships of the unemployed, as some quarters have asserted. Other measures of money have increased and I have already conveyed some of the problems of making the narrow money supply grow in a period when people are hesitant to commit themselves to new projects requiring more credit. Additionally, I have tried to show that we have already taken major steps to reliquify the economy and are moving cautiously only out of our deep concern for the ravages of inflation which tax both employed and unemployed and which were primarily responsible for our present recession, including the high level of unemployment.

Public policy must treat the recession but hopefully in a manner and timing such as to avoid a new round of inflation later on. With sufficient tax incentives capital spending and construction will be stimulated and, when inventory liquidation runs its course, new production will redevelop and economic recovery will be on the way. While we work to stop the deepening recession and the unemployment it generates, we should pay careful attention to the economic patterns our policies will create in the post-recession environment. With luck in the form of no further major price stimulants from abroad, no major crop failures at home or abroad, and no destabilizing exchange rate movements or control measures, it is possible to design policy moves which will stimulate recovery without regenerating inflation. But extremely careful formulation of public policy positions will be required to reach toward that new equilibrium for economic progress.

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