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The Financial Situation

Remarks of

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Tonight I am going to talk about money and credit, its supply, demand and cost and their potentials for the coming year. First let me set the economic scene because finances are merely a means to the end of purchasing, investing, saving and living. The economic environment is thus the result of, and cause for, the primary financial trends of the nation.

Since the trough of the recession in early 1975, the United States has experienced a major economic expansion. Real gross national product has improved by over 16 percent, industrial production rose 25 percent, and housing starts increased over one million units. Employment has risen by more than 8 million people to a level of 92.6 million at the end of 1977. The unemployment rate has declined slowly but by the end of 1977 at 6.4 percent of the labor force was more than 2 percentage points below the rate in early 1975. To many people the slow decline in unemployment represents one of the principal disappointments of the current recovery, but if one looks at the growth of the labor force, particularly from the increased participation of women in the labor force, the gains in employment represent a considerable achievement. The fundamental difficulties of the recovery which have kept the economy from creating even more new jobs, were such things as the slow growth in capital spending, the large trade deficit which reflects our increased imports but sluggish gains in exports, and especially the 17 percent inflation in the United States since the trough of the recession.

But we should not denigrate the growth of our economy over the past two years. We have truly had a remarkable recovery from a very deep recession. To put this in perspective we should look back against the prior peak and realize that we now have 8 percent more people employed today, a Gross National Product in real terms that is nearly 10 percent higher and an industrial production level, 6 percent above the prior peak. In other words, even though the recovery may not have been the most enjoyed recovery and prosperity this nation has ever had, it certainly has been a major one and it has moved us a long way from the difficult times of late 1974 and early 1975. In this period the financial conditions of the nation have changed dramatically. One need only think back on the difficulties of the real estate investment trust and of some large banks that were charging off major loan losses and whose capital positions were being impaired by heavy classified asset levels, to realize that in the financial world too, the United States has made major progress since the depths of the recession. But I'm not here to discuss the rate of growth of the economy or the rate of improvement in unemployment or the rate of growth in the number of employed workers in the United States. Instead I will discuss the financial situation, which I would characterize today as liquid, costly, confused and, in one sense, exposed.

In 1977 the nation's money supply grew at approximately 7-1/2 percent. The supply of credit available to the nation was clearly ample to meet the growth of the economy, especially from the heavy inflows of funds from abroad and because of the availability of funds to corporations through issuance of longer-term bonds and other debt instruments. The year 1977 for the banking industry was characterized by a shift away from demand deposits and savings and short-run time accounts to a greater reliance upon interest bearing negotiable CD's and other borrowed funds. Supplies were adequate to meet the test of the marketplace to finance a real gross national product advance of about 6 percent and a nominal advance of 11 percent in 1977.

Demand for credit from the private sector was especially strong in three major areas but relatively weak in others. The strength came in the real estate sector, as new home building increased and the multi-occupant condominium and apartment segment began to redevelop. In addition to this basic demand for real estate credit though, many homeowners found that they could withdraw the equity from their homes where inflation had bid up the prices, by means of new and second mortgages. The credit going into this form raised the total volume of real estate credit by a record amount.

A second area of strong demand came from the consumer credit sector where consumers not only purchased a high volume of new automobiles, electronic equipment and other similar durable goods, but also spent sizable funds for furnishing new houses and for the major appliances needed to equip them. At times during the year there was strength evident in securities demand, but as the market weakened in the latter part of 1977, security credit faded away.

Business demand accelerated during 1977 but was only moderately strong at the very large banks. Business credit needs rose more than 10 percent with a relatively strong demand at the smaller and regional money banks in the nation. But for the very largest banks, those in New York, Chicago, San Francisco and other similar spots the loan demand from business remained weak throughout the year. Part of this sluggishness was occasioned by the continued issuance of commercial paper by prime customers of these very large banks, and as commercial paper rates generally remained below the prime rates of the commercial banks, there was an attraction to short-run financing by this device. Another important element was the large volume of credit raised by issue of corporate stocks and bonds.

But even within the business loan sector, there were weak and strong elements. Some of the greatest strength in the business loan demand occurred in trade and mining sectors. On the other hand, durable goods producers, utilities, and transportation concerns showed little strength in demand for bank credit. In the public sector, there were strong demands from State and local governments and of course a rising demand from the Federal Government, especially toward the latter part of the year.

The cost of credit moved up slowly in the early parts of 1977 but by the end of the year short-term rates were up more than two full percentage points and long-term rates were up 30 to 50 basis points. Even at these levels, however, interest rates had hardly retraced a third of their total decline during the recession period. It is of special interest to note that the efforts of the central bank to accommodate the credit needs of the nation in a prudent fashion resulted in some increases in short-term rates but the long-term rates scarcely moved. Monetary policy was basically accommodative to the economic growth of the nation at a moderate pace but resistant to excessive growth in the economy or the monetary aggregates. Fiscal policy was basically neutral through the second quarter of the year and then became stimulative. An unusual shortfall of Federal expenditures showed up early in 1977 but after the Tax Act of 1977 and new legislation providing funds for a countercyclical jobs program, fiscal policy moved to a stimulative posture.

The financial situation of the United States was also characterized by unusual international movements in 1977. The trade deficit rose sharply during the year reaching a level of about $30 billion from a deficit of only $9 billion in 1976, and a surplus of $9 billion in 1975. With the growing market perception of our trade deficits, and the impact of foreign interpretation of U.S. policy as one of "benign neglect," the dollar grew sharply weaker. Not until resistance by the Treasury and central bank strengthened, was there any sign of improvement. Stakes of this international chess game are indeed high. Inflationary pressures from the dollar depreciation are an unwelcome guest in the U.S. household today. Not only are import prices likely to advance because of the depreciation, but with such advances U.S. corporations could lift their prices as competitive pressures weaken. In the long-range, of course, there should be a spur to United States exports and a diminished level of imports, but over the coming year, there will be adverse inflationary consequences.

Having described the financial situation for 1977, let us look at the trends for 1978 from the present perspective of the first month of the year.

It is clear that supplies of credit are indeed ample and liquidity is generally high not only for financial institutions but for a large number of the major corporations of the United States.

This liquidity is evident in not only the investment of companies in corporate and government securities, but also in certificates of deposit. It is also evident in the relative lack of bank credit demand from the very largest corporations. Thus, the supplies of credit, including those provided by the central bank are certainly ample for continued progress for the United States' economy in 1978. But these supplies are ample at a rising cost. The increase in the discount rate in early 1978, admittedly for international purposes, and the consequent general rise of market interest rates still reflect a higher cost to potential borrowers. The demand for credit during 1978, dependent upon the economy's performance, may be little changed from the private sector in total. There may be some increase in business loan demand at banks if there is a major move to rebuild inventories in the early part of the year, but recently such inventory shifts are of relatively short duration as corporations are keeping a much closer rein on their inventory-sales ratios.

Business demand could be larger than in the past year however, notably if corporations decide to enlarge their capital spending programs and thus utilize long-term funds for capital projects.

Consumer demand has held up quite well this past year and consumer credit growth has been very large. For 1978 such demand will depend upon the rate of growth of consumer credit to finance purchases of large ticket items. If one accepts the forecast of some major automobile producers that automobile sales will be weaker in 1978 than in 1977, and if homebuilding also weakens during the year, either from the pressure of higher costs or the lessened availability of mortgage credit, then consumer demand may well be reduced.

In summary, the supply and demand relationships for credit in 1978 from our present vantage point would appear to be in fairly reasonable balance for the private sector. However, if one adds the government demands, especially at the Federal level, one could envision a scenario which could bring pressure on credit markets during 1978. With the Federal Government budget deficit rising from $45 to $60 billion between 1977 and 1978, the credit needs from the Government sector may be sizable over the coming twelve months and this could bring some pressure on the supply of credit for the nation as a whole. Rate trends have been modestly upward with the exception of this recent flurry caused by the international side, but future trends will be affected by the rate of growth in the economy and monetary policy actions.

The international financial situation is, in my opinion, one of the principal question marks for 1978. U.S. international prospects from a trade standpoint are little changed from the evidence of 1977. Another large trade deficit will put additional dollars in the hands of foreigners for investment or sale to others and such net additions to the supply of dollars broad must be absorbed.

Offsetting some of the large trade deficits have been strong official capital inflows to the United States. Private capital inflows are likely to enlarge; a greater differential in interest rates between the United States and other principal industrial countries should encourage additional inflows of funds to the U.S. The spread is already more than 3 percentage points between the United States and Germany and Switzerland and is steadily widening against other major industrial countries as well.

Uncertainty in the exchange markets may continue over the coming year, but if there is no significant change in inflation or growth relationship between the United States and other principal industrial countries, the uncertainties should not be a cause for significant further deterioration in the dollar. Some developing export strength from the depreciation can be expected in the latter part of the year and indeed some may be underway on the order books of a good many companies. These coupled with some diminishment in the rate of growth of imports give us hope for new strength in our international financial relationships in the latter part of 1978.

I have tried to outline some of the principal factors affecting the United States in its domestic and international financial situation in the coming year. Let me close with a look at some policy alternatives which could be considered. As far as the international value of the dollar is concerned, it is clear that if the United States is intervening in the exchange market just to correct disorderly conditions and not to peg at a particular rate, then market forces will move the dollar exchange rate to whatever position the market believes necessary for balance between the dollar and other primary currencies. On the other hand, a policy to intervene to achieve a higher dollar rate would mean a massive expenditure of funds to counteract speculative pressures. Higher rates of interest in the United States can be of help in attracting capital flows but higher rates could also diminish domestic capital spending and could even interrupt the trend of recovery underway for the past two and a half years. A lower rate of inflation would obviously be a considerable help in the United States, but such does not seem likely for the coming year with the pressures from the depreciation already experienced.

Of course, over the long range, our international exchange relationships depend upon policies which will diminish our reliance upon foreign imports as a requirement of our day-to-day life. This means a strong energy policy to encourage conservation, to encourage the finding of new oil and gas within our boundaries, and to encourage the development of other forms of energy. Also important though must be the development of new efficient capacity in some of the primary industries where we are presently importing a material portion of the products purchased in this country. Capital spending is necessary not only for new capacity, but in certain industries may be critical for improved productivity by achieving the highest rate of technological efficiency. To develop such a capital spending drive, it will be necessary to encourage individual investors to see a commensurate rate of return on their investment and this will probably mean some form of tax encouragement by investment tax credits, rollover credits, or investment renewal credits over the coming years. Of perhaps greatest importance must be a slowdown in the rate of cost increases so that inflation can be brought under better control. We can no longer afford the luxury of government-sponsored inflation measures such as increasingly higher minimum wages, increased costs from activist legislation for higher wage levels and the widespread welfare and consumer expenditures of government which builds such a strong base of wage, tax, and governmental costs. These costs and others are a major contributor to our inflationary problems and must be brought under control to reinforce attitudes of investors around the world that the dollar is a safe haven for their funds and a desirable investment outlet.

It is rather apparent that government has not done its job over the past year in providing the leadership necessary to find an acceptable energy program, a tax policy to stimulate capital spending or an anti-inflation program to strengthen the dollar at home and abroad. If anything, Government has contributed to the uncertainties, and perhaps, most damaging, has fostered policies which are enlarging the inflationary pressure in this country. Such policies must be corrected before a long-range solution can be achieved to either the inflation or unemployment problems or to an improved exchange rate position.

It is clearly incumbent upon government to reduce its pressure upon the economy and credit markets, to reduce its wage stimulus, and to take policy actions which will lead this nation into a strong anti-inflationary posture. Finally, there must be a coherent, logical policy base to correct the imbalance in our international relationships. We cannot afford continued large trade and current account deficits which contribute to even greater dollar holdings in foreign hands.

In my view some of the policy actions needed are:

1. To reduce the wage pressure from government both for its own employees and for the nation by limiting future minimum wage increases, and encouraging private companies and unions to limit wage settlements.

2. To reduce expenditures and relieve Treasury financing pressure on credit markets by postponing major non-essential public works, reducing welfare spending, increasing direct borrowing abroad and tailoring Treasury maturities to the most receptive areas of the market.

3. To encourage private sector energy solutions by reducing government price interference and stimulating, by tax relief, the development of new programs.

4. To use its tax authority to discourage private waste of energy.

5. To develop a comprehensive program of anti-inflation actions including support for Federal Reserve limits on money supply growth, using tax incentives for capital spending, restructuring labor and wage legislation to encourage competition, and exerting leadership in the world financial markets toward greater stability and competitive pricing.

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