FOR RELEASE ON DELIVERY
Thursday, October 10, 1974
10:30 a.m. EDT

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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the

Business Outlook 1975 Conference
of the
The Conference Board in Canada

Hotel Bonaventure

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As a former producer of forecasts, I am particularly glad to be able to participate in your outlook session. For the United States, as well as for Canada, an understanding of what is ahead for its biggest trade partner is important. I am grateful to the Conference Board of Canada for providing this opportunity to discuss matters of common interest.

The Federal Reserve is no more and, I would add despite some contrary views I have heard, no less clairvoyant than other forecasters represented at this Outlook Conference. But information of how the Federal Reserve looks at the future might lead, or mislead, some people into believing that they can predict Federal Reserve policy. For that reason, the purpose of my remarks here will be simply to examine some of the special features of the economy's movement up to the present time.

The present cyclical movement indeed differs from its predecessors in many important respects. The unprecedented rate of inflation is only one of them, but it has had wide ramifications. For the United States this inflation is partly the result of supply factors, which we have not observed in anything like this virulence in recent cycles. But in part it is the result also of domestic demand and of wage behavior. In addition, it contains elements resulting from the decompression of wages and prices following the removal of controls.

The supply factors for the most part have identifiable roots which one hopes and believes will vanish at least in part. The component in food prices reflecting adverse crop developments in the U.S. and abroad, rather than higher costs, should eventually yield to the response of output to higher prices. The unwinding of the international business cycle should have similar effects as regards many other commodities, although each one presents different circumstances. Capacity shortages in primary manufactured products are being overcome with increasing rapidity. These bottlenecks, together with the effort to rebuild profit margins that were severely squeezed heretofore, probably have contributed considerable pressure to the price structure.

Whether the price of oil will also prove subject to market forces no one can say with assurance at this time. What can be said is that, unless the price of oil comes down, some countries may face problems that they cannot solve by their own efforts. Canada is fortunate in being relatively free of worries about oil supplies.

But while some of the forces driving the recent inflationary surge may be losing strength, wage increases could now acquire a momentum that would make it difficult to reduce the rate of price increase. In the United States, the rate of wage increases has accelerated, with average hourly earnings (in manufacturing, adjusted for overtime and inter-industry shifts) running at an annual rate of growth of 11.1 per cent for the six months ending with September. Average hourly compensation (for the private non-farm economy, including fringes) was rising at an annual rate of 10.5 per cent for the second quarter of the year. Steep wage increases are no longer limited to newly concluded contracts, because many of the older contracts have escalator clauses. Many employers of non-unionized workers, moreover, who abided by past wage ceilings, are now giving catch-up increases. As the present high increases are built into the wage structure, ending this inflation will become increasingly difficult, slow, painful and costly. There is one compensating factor: to the extent that the supply factors improve, the escalators will translate a slowing of the price trend into a slowing of the wage trend which will once more slow the price trend.

Pressure for higher wages is very understandable, in view of the fact that average hourly compensation in real terms (private non-farm) has declined each quarter beginning with the second quarter of 1973. But in view of the rise in real costs a catch-up for wages is not possible in the short run except by taking something from other recipients of the national income. The very poor performance of productivity, which peaked out in the first quarter of 1973, has contributed to cost and price pressure. However, since some of this poor performance very probably resulted from supply shortages, a catch-up of productivity ought to be ahead that should help slow the movement of prices and, through the effect of wage escalators, also that of wages. Thus the view which holds that inflation can be brought down but that it will take a considerable time finds support in the particulars of the supply and wage situation.

The present cycle has seen demand shifts of unusual kinds. For the most part these contribute to a reduction in consumer demand. One instance has been the shift of income from the general consumer to the farmer. Farmers tend to save more than others in the same income bracket and sharp increases in income of course are particularly likely to generate a sudden spurt in savings. Partly reflecting this, the savings rate in the last quarter of 1973 rose sharply to an exceptional 9.5 per cent, although it has come down just as sharply since then. A further income shift has resulted from the higher price of imported oil.

The impact on consumers of what has been called "a quasi-excise tax" on oil does not, of course, show up in higher personal saving, but only in reduced consumer demand. The massive increase in oil payments to the oil-exporting countries, of the order of $20 billion in 1974, is compensated in part by a rise in non-oil exports, especially of farm products. Thus, the reduction in aggregate demand implicit in a drop of net exports from $11.3 billion in the first quarter of 1974 to minus $1.5 billion in the second does not fully reflect the "quasi-excise tax" paid to the oil-producing countries. But the current weakness of consumer expenditures measured in real terms cannot be unrelated to it.

So far, the "quasi tax," adverse as its implications are in all other respects, has helped restrain the forces of inflation.

But if the price of oil should remain near its present level, one must ask also how the resulting purchasing power gap can be employed to create a desirable structure of over-all aggregate demand. The answer is not difficult to visualize if the OPEC countries should decide to invest in the United States the proceeds of their increased oil sales to the country. In that case, the reduction in consumer demand could be converted into an increase in investment demand, assuming effective functioning of the capital markets in an economy where activity is well maintained.

The same shift, however, could occur also in the event that the OPEC countries should decide to invest none of their proceeds in the United States. Some or all of the dollars paid by the American consumer for imported oil might then be sold by the oil companies or the oil-producing countries in the exchange market. Under the present floating rate system, this would drive down the foreign exchange rate of the dollar and hurt real income by depressing the terms of trade. But it would not affect the volume of money in the United States nor, broadly speaking, the level of interest rates. The exchange rate of the dollar would go to whatever level would induce foreigners other than the OPEC countries to acquire and hold dollars. These new holders then would have to invest their dollars, through the banking system or directly, again adding to investment demand.

The decision of the OPEC countries whether or not to invest in the United States would affect the level of the exchange rate and the structure of interest rates, since alternative investors probably would have different asset preferences. But their decision would not affect the money supply (except perhaps shifts between M_1 and M_2) nor the level of interest rates as influenced by that money supply and its rate of growth. The net result might very well be an increase in investment, as well as net exports, relative to consumption.

This brings me to another feature of the present cyclical situation that distinguishes it from its predecessors. Plant and equipment spending continues at a very high rate. This does not show up so much in total gross private domestic investment, because of the sharp drop in housing and inventory expenditures since the fourth quarter of 1974. These investment figures, to be sure, fall far short of the high levels of investment that some observers say is needed to remove bottlenecks, meet environmental requirements, and create substitute sources of energy. But it is nevertheless noteworthy that investment expenditures have been so well maintained during a period of growing slack of now two or three quarters.

This good performance of business fixed investment has been obtained despite the rapid deterioration of retained corporate profits. The story of profit illusion in the corporate sector has been told many times and I shall merely summarize it. In superficial appearance, corporate profits before taxes have returned to their old benchmark level of 10 per cent of GNP or have even gone a little beyond that. But this contains an Inventory Valuation Adjustment -- capital gains on inventory due to inflation -- of about 3 per cent of GNP, upon which of course taxes must be paid. It also contains the profits of financial corporations, including the Federal Reserve, and profits earned abroad which usually are not available for investment in the United States. Adjustments must be made also for the under-depreciation that, despite accelerated depreciation techniques, results from the use of the unrealistic original cost base for depreciation purposes. After all these adjustments are made, the domestic profits of non-financial corporations turn out to be well below their dividends. Retained profits have become negative.

Had this talk been given a few days earlier, I would have been tempted to refer to what then would have appeared to be still another perculiarity of the present cycle -- a relatively moderate increase in unemployment given the prolonged absence of growth. The latest unemployment figures give a different story. Since the one-month rise from 5.4 to 5.8 per cent was the result of a very unusual increase in the labor force further insights into the course of the unemployment data in 1974 must be awaited.

More revealing than the over-all unemployment rate, in any event, is the figure for married males. These are the core of the labor force. They decide about union contracts. Their unemployment is the real test of labor market ease or tightness. The unemployment of married males in September 1974 rose from 2.6 to 2.8 per cent. Their long-term unemployment (5 weeks and over) which normally amounts to somewhat more than half the total unemployment for the group, is an even better index of conditions in the labor market and suggests that at the present time conditions are still far from easy. Meanwhile the urgency of acting to cope with teenage unemployment, which rose from 15.3 to 16.7 per cent is mounting.

I referred earlier to the flow of OPEC funds and to their possible investment in the United States. These funds, especially as regards their recycling to third countries, have become a novel and important feature of the international business financial scene. The behavior of these flows also affects the banking system, about which concerns have been voiced of late. The evidence seems to show that the vicissitudes that have befallen particular banks have been the result of particular management errors and defects, rather than indications of a pervasive weakness. I believe that the banking system, prudently managed -- and especially with lender of last resort facilities in place -- is in a good position to take care of itself. The tightening of internal and of supervisory controls that is in progress in most countries will contribute to that capability. This implies, however, that individual banks will know where to draw the line as regards the volume and the term of the deposits that they accept, and with respect also to the quality and maturity of their loans. It is unlikely that the entire burden of accepting and redistributing OPEC funds, the so-called recycling process, can be carried by the banking system.

At the present time, some countries, in addition to their oil deficit, have a non-oil deficit, while others have a non-oil surplus. The United States is an example of the latter type of situation. Countries unable to obtain credit to finance even their oil deficit would have to adjust further and eliminate not only their non-oil deficit, but would have to develop a non-oil surplus to offset part of the oil deficit, to the extent that conservation and substitution cannot reduce the oil deficit. Such measures would have the effect of course of reducing the non-oil surpluses of other countries and perhaps pushing them into non-oil deficit. Exchange rates might shift in the process, particularly if direct trade restrictions and severe domestic deflation are to be avoided.

In this process, it is important to achieve a reasonable degree of adjustment without creating major disturbances in international trade. I think it should be well understood that precipitous creation of large credit facilities could reduce unduly the pressure to adjust, and might have inflationary consequences for the entire world. Furthermore, an unwarranted impression might be created by such an attempt to press the solution of the recycling problem that the present price of oil is readily manageable. This would reduce the pressure upon both buyers and sellers of oil to bring down that price.

But inadequate recycling facilities, leading to drastic efforts at adjustment, would be dangerous in an opposite sense. This may mean that some of the countries in need of funds might not be able to obtain the credit they desire from private banks or indeed from the open market. Unless other supplementary credit facilities are created, the countries in heaviest deficit would have to make major balance-of-payments adjustment.

In any event it is probably an illusion to think that one or two major recycling facilities can deal with the financing problem created by high oil prices, even if these prices come down. A wide dispersal of credit flows, through many institutions and markets, and in many different forms, seems to offer the best prospects for coping with the OPEC investment flows.

In conclusion, I would like to say a few words about the recent stance of monetary policy in the U.S. Those of you who observe the narrow money supply (M1 -- currency plus demand deposits) will have noted that its growth rate over a considerable period has been below the growth rate of nominal GNP. At the same time, the growth rate of M1 has been higher than it would have had to be in an economy free of inflation. In other words, there has been a significant increase in the money supply which has facilitated the functioning of financial markets. Income velocity has nevertheless been rising. Confronted with this fairly steady restraint, the financial market has exerted a rather variable demand for money and credit. As a result, short-term rates have fluctuated substantially. Their recent decline may be viewed as a response of the market to the restraint applied, and this mild easing in market rates may be viewed in that sense as one of the first fruits of that policy.

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