

REFLECTIONS ON 1974

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by

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To say that 1974 has been an unusual year would be a masterpiece of understatement. It brings back Thomas Paine's well known phrase, "These are the times that try men's souls."

It is unlikely that a single year has ever before seen so many turn-overs of government in industrialized capitalist countries. Rates of inflation around the world rose to levels seldom seen before. It was a year of world-wide recession with the pace of economic deterioration accelerating as the year ended. Interest rates in the United States and other principal financial markets rose to record or near-record highs. Ominous strains appeared in the international financial system at mid-year, raising the unfounded fears of financial crisis.

As the year ended, international oil prices remained at the high levels established earlier in 1974, while both importing and exporting countries had just begun to recognize the threat to the stability of world economic order posed by these oil prices and the surpluses they were generating for the oil exporting countries.

The pace of 1972 and early 1973 was too fast to be sustained. Even if inflation had not accelerated, the economy was headed for trouble. Inflation made it a certainty. With inflation hitting double digit figures, consumer take-home pay dropped, leaving less to spend. The manufacturers in various

lines soon produced more than retailers could sell. Earlier shortages gave way to surpluses, making output reductions and layoffs inevitable. The recession had arrived and with it came a re-learning of an old lesson. Rather than being a well-oiled machine, the economy races and sputters. It takes time and some pain to adjust.

Sure, we are in a recession. In fact, it looks as if this recession may become the longest since World War II and perhaps even turn out to be the most severe. On the other hand, we should guard against becoming despondent. We have experience dealing with recessions. We contained them in the past. We will again. This is a time for keeping one's perspective.

Conditions are considerably different today from those of the Great Depression. The problem we faced in the Thirties was not inflation, but deflation. Wholesale prices were falling sharply, thus putting a heavy burden on persons in debt. Today, of course, we have exactly the opposite situation: rising prices and a lighter debt burden. We had an unemployment level of 25 percent. Industrial production dropped about 50 percent compared with 5 percent in 1974, and farm prices less than half their 1929 level.

Here are some other differences: In the Thirties, a higher gold price was advocated to increase commodity prices. Today, the gold price is pushed up by a speculative fever that has engulfed many commodities.

In the Thirties, the amount of money was declining; by as much as one-third, in fact, between 1929 and 1933. Today, the money supply is increasing at normal rates.

In the Thirties, we had no protection against collapse. Today, we have considerable protection.

In that period, those who were out of work quickly became destitute. Today, we have unemployment insurance compensation and programs for public service employment.

Working along the same lines are the supplemental unemployment payment benefits that automobile and other workers receive under union contracts. There are additional economic cushions, such as food stamps, welfare payments, social security, and pension funds.

Call them protections, deterrents, cushions, safeguards, or whatever you like. Remember they do exist.

In recent months I have been asked frequently about the soundness of our banking system. Whenever I replied that I saw no cause for alarm, I received some very skeptical looks. So, let me use this forum to state most emphatically that I see no danger of a major financial collapse or liquidity crisis. Some large banks here and in Europe have gotten into trouble, but these problems have arisen from the management practices of specific banks rather than from the structural weakness of the entire banking system.

In a banking system with well over 14,000 banks, it should be expected that some institutions would become over-extended and experience larger than average loan losses. These banks show up on the FDIC's problem bank list which now includes about 150 banks, actually somewhat fewer than two years ago.

What is the Federal Reserve's part in all of this? One of the fundamental duties of a central bank is to act as a lender of last resort to banks that are solvent but are faced with a severe liquidity problem, usually a heavy run-off of deposits. The resources of the Federal Reserve are enormous, if not limitless, and are entirely adequate to handle any foreseeable situation. The Federal Reserve is fully prepared to assist sound banks and, if necessary, to lend on an emergency basis to nonbank financial institutions.

One of the great reforms has been the insurance of bank deposits. There was no such insurance in 1929.

I am not afraid of economic collapse. What I am afraid of is that we might talk ourselves into economic conditions that are worse than they really are and end up with a deeper recession.

It will take a pick-up in consumer buying to help turn the economy around, and this requires consumer confidence. Businessmen need confidence as well. Before they buy new equipment and build new facilities, businessmen need confidence that their long-term sales curve is headed upward. Confidence is at the heart of consumer and business decision-making.

What if there is no loss of confidence? Then, I think chances are the current recession will end like most previous ones. After all, there comes a point when businessmen have less goods on their shelves than they consider necessary, so they start reordering. And as credit becomes easier, the consumer becomes more tempted to buy a home; all of this tends to increase

demands and bring an end to recession. Thus, I repeat: Let us guard against talking ourselves into a first-class recession.

It's a phenomenon well known to housewives, generals, and football coaches, though few act on it as decisively as Tom Sawyer's Aunt Polly. Having broken one plate accidentally, she would smash two others deliberately just to get it over with, muttering that trouble always comes in three's.

We suffer from three separate misfortunes which by happenstance came simultaneously while we persist in talking about them as if they were one.

We suffer from (1) a monetary inflation; (2) an oil shortage; and (3) a crop failure. The effect of each is to raise prices and the effect of all three together is to raise prices more than somewhat. They are nonetheless three different woes.

First, the monetary inflation. This has been with us for a long time. It is the result of years of wrong monetary and fiscal policy. The doctrine was that a little inflation was not only a good thing, but actually necessary to keep the economy growing and to stave off unemployment and recession. So, from World War II on, with only three interruptions, our government has persistently spent more money than it took in. Largely under the impact of the Korean War, problems began to emerge. Even if nature had not been so unkind or the sheiks of Arabi so manevolent, we would by now have a depreciating dollar with a rapidly rising price level.

That would have been troublesome enough. Nature and the oil producing countries compounded it. Last year's droughts and floods, by cutting crop

supplies, added to the cost of food, the most noticeable item in a family's budget.

All of us had to become instant experts on oil, and I, for one, must confess I still don't understand some of the ins and outs. Yet, several things are clear. First, the quadrupling in oil prices has caused, in addition to inflation and unemployment, severe economic problems for many nations and has had troublesome effects on the world's financial system.

Because we luckily produce much of our own oil, these problems are less serious for us than for many other countries. But they are real, even for our country, because the higher oil price has intensified our inflation and has turned our overall trading account into deficit.

On the other side of the coin, members of OPEC are accumulating oil revenues at something like \$50 billion or \$60 billion annually. They have not had enough time to draw up plans for using these funds for their own economic development, and they have been reluctant to invest them in foreign real estate, stocks, and bonds. Instead, they have placed the greatest part with private U. S. and British banks, which in turn have made them available to credit-worthy borrowers, including some of the oil-consuming countries. This is what is meant by the term "recycling."

There are limits to how much money can be recycled or channeled in this fashion. It cannot go on for too many years because it involves a continuous piling up of debt.

Pulling answers out of this morass is difficult. But as a starter, I'd like to see the greatest pressure to roll back oil prices and an intensification

of energy conservation. An effective conservation program is also vital to the economic health and fortune of our own country. What we need to do is find ways to reduce our own use of oil and our dependence on imports.

The multiplying of oil prices added to the cost of just about every industrial product. These extra pressures on prices have been piled atop the basic monetary inflation with disastrous results.

So far as the ordinary citizen is concerned, all of this is inflation because it means his dollar buys less. But the distinctions are important for several reasons, not the least of which is that the remedies for one will not necessarily remedy the other.

The monetary and fiscal policies which can and should be adopted to check the monetary inflation will not by themselves increase the supply of either food or oil. The budget policies of the President will not assure good crop weather and monetary policies of the Federal Reserve will not nullify the Arabs.

Conversely, neither a benevolent Nature nor an amiable Saudi Arabia, however welcome both would be, are going to relieve the basic pressures of our monetary inflation. If they continue unabated, we could well find that even increases in food and oil supplies would not halt the rise in the general price level.

The latter is especially important to recognize now because there is a tendency to blame most of our inflation on these crop failures and oil blackmail, with the Congress showing little disposition to deal with the monetary

inflation either by raising taxes or reducing spending. These make handy scapegoats for bad economic policies.

If we had had a stable dollar with no internal inflationary pressures, we would have been in a far better position to meet the strains of the crop shortages and the oil crunch. Prices would be going up but not at their double digit rates, and they would not be threatening to keep rising.

Given the spread of the current downturn and its pervasive nature through most industries, it does not appear too likely that economic performance in the first quarter of 1975 will be any better than in the last quarter of 1974. The most that can be hoped for is that before mid-year the economy will have begun to bottom out and that a base will be forming on which recovery might be built in the second half of the year.

I just don't believe we can ignore the double-digit inflation. On the other hand, I would be guilty of gross exaggeration if I told you the battle against inflation now demands highly restrictive credit and a deliberate budgetary surplus. These are obviously policies that can help curb excess demand and thus work against price pressures. But excess demand is not a problem now and, therefore, not a source of inflation.

Yet another contributor to high inflation rates is the exercise of power by some labor and business groups. Over the past year, for example, wages have gone up by about 9 percent, while productivity has declined by 2 percent. This has pushed up labor costs by 11 to 12 percent--a surefire ingredient in any inflation.

Some wage increases are justified by the loss in buying power.

Some business firms have granted generous pay hikes on their own volition. But what I find objectionable is that some unions, by using their great power, have demanded and gotten extremely large wage increases, which businesses then passed through to consumers in the form of higher prices.

Not only some unions, but some large industrial firms, possess great power, which they sometimes exercise against consumer interests. How, for example, can one justify the price increases announced by certain companies even while their sales are coming down?

What all of this suggests to me is that we need less market power and more competition. We also need to eliminate those governmental rules and regulations that curb competition.

Much that happened during the year now ended offered reason for gratification. The adaptability of political and economic processes certainly support confidence in the future of Western institutions. The turnover of governments in most countries was accomplished through democratic processes and in almost all cases the new governments were stronger and better able to govern than their predecessors. Despite economic weakness and growing unemployment, most countries around the world adhered firmly to policies aimed at eradicating inflation as the number one evil and did so in a free market setting.

As the pressures rising from our present economic sickness generate increased political and social responses, there can be no firm guarantee that

cracks will not appear in the existing order, but thus far the liberal political and economic systems of the Western world are indeed behaving well.

The industry hardest hit in recent months has been automobiles, and it is here that a turnaround toward improved production and unemployment might first be visible, perhaps in the early months of 1975. The steep slump in sales of the new 1975 models has been due to a variety of causes, including promotion efforts which moved a large number of automobiles late in the 1974 model year, higher prices of the new models, and the effect of the recession as it manifested itself in consumer caution toward making major new purchases.

Sales of the new models actually had been running below the normal rate of scrappage of old cars for the last few months. This fact lends support for the hope that sales might soon turn upward, at least to equal scrappage rates. Also, the suddenness of the sales dip has created for the industry a severe inventory overhang, causing manufacturers to cut production even below the low level of sales in an effort to restore a better balance between inventories and sales. Once inventory balance has been restored, an increase in production then will be necessary to maintain that balance. Given the severely depressed state of consumer attitudes, there is no reason to expect 1975 will be anything but a poor year for automobiles. But, there still should be some improvement over the disastrous record of the past three months.

Another important industry where a turnabout might occur before mid-1975 is residential construction. Housing starts in the three months, September through November, held at an annual rate down more than 50 percent from the

level of starts in 1972. Starts might slip even further during the first quarter of 1975, but surely most of the correction in this industry is now behind us. Meanwhile, it should be expected that aggressive policies aimed at making mortgage money more readily available will gradually improve mortgage money supplies and help to support a gradual increase in housing.

The current level of housing starts also has had a negative effect on appliance, furniture, and other major consumer items. The weakness in housing completions side by side with the thoroughly demoralized state of consumer attitudes probably assures that these important industries will lag behind in terms of the better performance in the economy generally.

An important reason for the recent spread throughout industry of the recession is the rather generalized excess inventory condition that has emerged in most industries from raw material production to the retail level. While the present efforts to bring inventories down to levels that are better balanced against the level of final sales are having a severely depressing influence upon the economy, there is a ray of light in this situation. As in the case of automobiles, an inventory correction requires that production be cut temporarily below the level of sales, exaggerating the weakness in the economy.

As proper inventory-sales ratios are re-established, however, production has to be increased just to maintain this ratio and the resulting advances in employment and income have in past recessions tended to build the base of

solid economic recovery. It is this tendency of an inventory recession to be self-correcting that has led many economists to predict that the present recession will take the form of a V, with two or three quarters of sharp decline promptly followed by a strong recovery.

An impressive amount of evidence has accumulated in recent months to support the proposition that price inflation at long last is being restrained. Prices of most basic materials have fallen significantly from their high levels of early last year. In a setting of falling demand and excess supply, the forces of competition enabled many buyers, both households and businesses, to shop around and effectively resist any efforts to raise prices. Industry is pursuing strong cost control programs which should prevent productivity from declining further. And, as any Christmas shopper is aware, the number of pre-Christmas clearance sales was unprecedented, and there is every indication that these are being followed by even larger post-holiday markdowns. It is unfortunate that some of the sales are and will be distress sales by companies on the edge of bankruptcy.

If inflation is in fact turning the corner, it is particularly important that the fact be reflected as early as possible. If inflation appears to be continuing unabated while unemployment continues to rise steeply, there is a real danger that Congress and/or the Administration might be driven toward adoption of price and pay controls out of frustration that conventional policies are not working. In spite of discussions to the contrary, there probably is not too much active interest in a return to controls at the moment in business,

labor, or the Administration, or for that matter, the Congress. But each passing month that does not give evidence of success in shaking inflation adds to the risk that policy might revert to direct controls.

Despite his ideological opposition, President Ford couldn't face the voters without a program to control inflation. There would be no politically feasible alternatives to mandatory controls. According to a recent Gallup poll, no single issue since World War II has so dominated the thinking of voters as inflation does today. The survey shows that 81 percent of the public regards the high cost of living as the nation's most important problem. By contrast, even as recession signs worsen, unemployment ranks as the number one worry with only two percent of the people.

It is not yet widely recognized, but because of the built-in stabilizing effect of the present income tax structure, the Federal budget has already moved into a very sizeable deficit, probably on the order of \$20 billion to \$25 billion for 1975, and a larger amount for fiscal 1976, even without enactment of large new expenditure programs or tax cuts. The substantial enlargement of the budget deficit over what had been expected only a few months ago has been due primarily to reduced rates of growth in personal income and corporate profits, which have resulted in lower than expected tax revenues.

A deficit of this size would seem, all else equal, to be able to provide all the stimulus that the economy is likely to need in 1975. But there are many things that can be done within the total budget that could be helpful

toward avoiding throwing the budget further out of balance. On the expenditure side, there probably is latitude for significant reductions in nonessential areas to help pay for essential increases. But identifying the areas where cuts might be made would take too long, although this should be given high priority as a long-term matter.

On the revenue side, much could probably be done through a comprehensive overhaul of the tax system that would in a framework of equity eliminate some obvious tax inequities. The tax reform is also a long-term project. Meanwhile, there, no doubt, will be and probably should be, moderate tax reductions of particular benefit to low income tax payers.

One simple way to avoid this outcome, with the incidental benefit of encouraging energy conservation, would be a sizeable increase in the excise tax on gasoline, perhaps on the order of 20¢ a gallon. Even with full rebate or tax credit of the excise tax on low income groups and those who must drive more than the normal person, such a tax could raise at least an estimated \$10 billion to \$12 billion, which would approximately offset the cost of the essential expenditures and tax reductions.

The effect of a gasoline tax increase would not obviously stop with the reduction in the use of gasoline. Whatever money is collected on the additional tax would represent a withdrawal of purchasing power that might otherwise have been spent on other products. The gasoline tax proposal, therefore, combined with the use of the funds to minimize the inequitable impact of the recession upon some groups would constitute an income

transfer through budgetary processes among different income groups and different industries.

Recipients of public employment funds and unemployment compensation would tend to spend this additional income on essentials, such as a better diet, clothing, medical care and similar expenses, while those paying the tax might reduce their spending on hard goods and less essential or impulse items. On balance, however, it should be expected that the out payments on public employment and unemployment compensation would have a maximum multiplying effect. That is, virtually every dollar disbursed would flow into spending while those paying the higher tax would not reduce their spending on other products by anything like the full amount of the tax. On balance, therefore, the income transfer would prove to be a stimulating influence for economic activity.

The exercise in self-discipline in which our country is now engaged carries a heavy cost and in some individual cases, a tragic cost. More liberal unemployment benefits can cushion the income loss for the person laid off because of the recession, but they cannot fully replace income, and they do nothing to offset the effect upon the morale of the person who finds himself out of work. For the individual businessman or investor who loses his life savings because of a business failure, there is little offset to the tragedy. It is one thing for an economist or the public official firmly entrenched in his job to recommend discipline. It is quite another for the victim created by that discipline.

Still, the urging of discipline in most cases does not reflect callous disregard for those who must suffer. It reflects instead an attempt to balance the long-term benefits for all people and for the continued viability of our type of system because of the short-run hardships endured in achieving the desired outcome. Everything else aside, the severe recession and the attendant hardships will result in a healthier, sturdier economy and society. If our system is to function, it must recognize that an essential part of the right of free choice, the right to take risk, the right to be free, is the danger of being wrong or of being a victim of forces over which the individual has no control.

There is no firm assurance that the present episode in our history will correct once and for all the mistakes of the past quarter of a century. There can be no firm assurance that inflation will in fact be brought under control or that even if it is temporarily controlled that the mistakes of the past will not be repeated in the future, leading to a replay of our recent history. But, when one considers the alternatives to not making the effort, alternatives that would involve a continuing intrusion of government in all aspects of life and thereby a continuing loss of independence, it becomes patently clear that the effort is more than worthwhile. It is essential.

Running a successful business enterprise calls for ethical men with the wisdom and patience to make prudent and responsible decisions in a highly competitive and fast-changing market.

There have been many voices in recent years telling us that our system, rooted as it is in the concepts of the 18th and 19th century liberalism,

is out of touch with the realities of the modern world. The power of huge corporations or large unions of media influence and behavior have so changed the world that economic concepts and policies of our free social structure need re-thinking and alteration. Perhaps this is so. But, before accepting that proposition, it is incumbent upon us to attempt to preserve what we have through the sternest efforts to make it work. If inflation is brought under control, and if by a year from now a healthier economy is launched once again upon the path of solid growth, we will have succeeded in preserving what many of us consider to be most valuable.