

CAN WE AFFORD THE FUTURE?

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by

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Talking about the state of our economy with this sophisticated audience of Rotarians is an awesome responsibility.

The question I pose today is: Can we afford the future? If I were sitting in the audience, my response might be, as most of yours surely must be: "How can we?" Over seven and a half million Americans are unemployed. Fourteen million collect welfare. Almost thirty million are on food stamps. The Federal government's current fiscal budget is \$75 billion in the red. The national debt exceeds \$550 billion. It seems we can't even afford the present.

Why, then, should we pose the question of affordability, to say nothing of the future? Because we have no choice. We cannot escape the future. What we can do is to anticipate the future as best we can.

Remembering how many forecasts have gone awry, we should admire the courage of economic forecasts and take them with a grain of salt. But far more important than numerical predictions are the climate and problems we are likely to encounter as this new year progresses. Let me share with you how we view the economy right now.

Compared to the pessimists and perpetual harbingers of doom, we are optimistic.

In recent months, several clouds over the economy have cleared away: agreement on the New York City situation, continuation of the

Federal tax cut, and emergence of a domestic oil policy. With these three questions resolved, at least for the moment, the economic outlook becomes brighter. As late as two months ago we thought New York City might default; we feared the chilling impact this could have had on the economy and financial markets. New York City's financial problems are far from over, but the threat of immediate bankruptcy is gone. The financial markets and economy have escaped consequences unpredictable in intensity yet clearly adverse in effect.

Then, just before Christmas, there was the tax-cut confrontation between the President and the Congress. The President wanted tax reductions tied to spending restrictions. The Congress opposed such restrictions. The compromise, of course, provided an agreement to extend the 1975 tax cut for six months. Political commentators may debate whether the President or the Congress won this fight. But from the standpoint of the economy, the general public won. Higher taxes would have reduced consumer spending power and slowed economic recovery. The tax compromise avoided an almost certain setback to the economy's upward momentum.

For many months we worried about the inflationary impact of abruptly removing price controls on domestic oil. A new law providing for gradual decontrol has now removed this concern. Had decontrol been immediate, prices on oil and oil-related products probably would have increased just as immediately, hurting both the fight against inflation and the economy's short-term prospects. Allowing domestic oil

prices to rise gradually cleared away another potential stumbling block on the road to economic recovery.

More than many of us realize, our economy's prospects are crucially tied to progress against inflation. In the Fifties and Sixties, economists told us a little inflation either didn't matter or even stimulated the economy. However, recent experience has taught us differently. The early Seventies brought not only rapid price increases but severe recession. Squeezed by growing inflation, many persons found the greater well-being they had thought was theirs to be a myth. Increased income failed to keep pace with losses in purchasing power caused by more inflation. Lessened purchasing power caused people to spend less, reducing output and employment too. As a result, the United States experienced its worst economic slump since the 1930's. Nor were we the only country to find inflation and prosperity incompatible. Japan, France, Germany, and many other nations learned the same lesson.

Inflation remains one of our most fundamental concerns. It is the single greatest disruptive economic force in the western democracies and a long hard struggle lies ahead if it is to be controlled. The better we control it, the better will be our grasp on prosperity.

Inflation in this country cannot be considered controlled when it is running in the 6- to 8-percent range. But current inflation is far below the double-digit rates of late 1974. This is, in fact, one of the reasons for my optimism.

Another encouraging sign is that employment is growing. During the last eight months, more than 1.5 million persons were rehired or have found new jobs. More people are at work and a job-seeker can now find work much more easily than he could last winter. Though the unemployment rate is still far too high, it, too, has come down.

These events did not develop by accident. Tax reductions have put more money into the hands of the consumer, who lost no time spending most of it. The majority of Americans have never taken an economics course in their life, but they understand one rule of economics well: Less taxes and less inflation provide more take-home pay, and more take-home pay generates more spending. Last spring and summer consumers followed this rule to the nth degree. In the fall, some spending hesitancy developed as governmental deficits and faster money creation became a smaller driving force than when the current economic expansion began. Who came to the rescue? Again, the consumer. As any Christmas shopper can attest, for many retailers December was a strong sales month by any standard; for some, it was the best Christmas ever, turning the consumer into Santa Claus for family and merchant alike.

All of this shows that consumers, under the right conditions, are still the key to the economy. By generating momentum, government fiscal and monetary actions can help economic recovery. But, in the final analysis, the private economy and the market mechanism seem to have the most influence.

Let me remind you: From time to time, the laws of supply and demand get stretched out of shape, yet they are very resilient. Food supplies, industrial materials, even energy are much more plentiful now than they were two years ago. The shortages of gasoline, fertilizer, and sugar we went through then are no more. Prices of fertilizer and sugar have come down a long way toward their pre-shortage levels. Because of a worldwide oil glut, even gasoline prices have started downward, and these would be much lower if the OPEC nations had not limited their oil production.

All of this indicates that today's businessman operates in a climate different from a year ago. Supply is more orderly; demand more spirited; and the price structure is more stable than it has been for a good while. This, too, is a basis for optimism.

We have been reflecting on where we are. Now, where are we going?

Again, we are optimistic. The economic recovery seems to be on track. We would be surprised if it did not continue through 1976. Should this recovery fail to make it into 1977, it would be almost a historical first. Since the 1920's, no economic expansion has lasted less than two years. Though this in itself is no guarantee, it does lend comfort. Every recovery seems to develop a built-in momentum that maintains the expansion for some time.

More specifically, we expect consumer spending, inventory accumulation, home building, and capital spending to keep the expansion alive.

Let me briefly tell you why. The consumer has more real income at his disposal and has struggled successfully to reduce his debts. His purchases of autos and other big-ticket items during the past two years have been far below trend. This has created a pent-up demand that is of special encouragement to Detroit. Domestic new car sales between late '74 and December '75 have advanced from a 5 1/2-million annual rate to 8.3 million. This large increase has been partly at the expense of imports, proving that we are finally meeting the foreign competition head-on. Detroit looks for some additional, though modest, gains for what, we think, are good reasons: the forementioned backlog of auto demand; the higher incomes and greater credit use; the greater gas thriftiness of the new models; and the leveling in gasoline prices. Provided inflation does not sap consumer confidence again, 1976 should be a good year for automobiles and retail sales in general.

A consumer's confidence is a major influence on his spending. Indications of consumer sentiment are hard to interpret. The results depend on who does the surveying and when. But all major surveys today report sentiment has improved, though confidence is not yet high. The consumer is still worried about prices and unemployment. A recent Gallup poll tells us seven in ten Americans expect 1976 to be a year of economic difficulty.

That consumers should act as if they have greater confidence in the economy yet continue to express a cautious attitude is understandable. Consider the surprises of the last few years: the four-fold jump in oil

prices, the shrinkage of jobs. But in time people are apt to forget these shocks. And the recent rise in stock prices should make them feel richer. So consumers should become freer in their spending. I am confident that they will if inflation can be held to moderate proportions.

Inventories are another area where caution is the watchword. Remembering the earlier frenzy of inventory accumulation and the overstocked aftermath, businessmen have been slow to rebuild inventories. Their caution casts doubt on rapid inventory accumulation soon. Nonetheless, modest inventory rebuilding is already under way. The pipeline is empty for more and more products; businessmen are recognizing they will need more goods to meet growing sales.

Residential housing will provide only modest support to the economy this year, and for good reason. Home construction dried up in 1974 and '75, particularly in the Southeast. However, there is a latent demand for housing that points to housing recovery down the road. The housing rebound has been understandably disappointing. Towering land, labor, materials, and high interest costs have priced many buyers out of the market. New construction activity has been hindered by an oversupply of condominiums and apartments, which will require time to digest.

Housing is a volatile industry, and detailed forecasts of cyclical sectors are notoriously poor. But in a longer perspective, the trend is clearly favorable. Continued population growth should stimulate residential building. In addition, the proportion of potential homeowners in the population is increasing dramatically: People born in the 1940-to-1960

baby boom are moving into the 30 to 44 age group, a group which typically upgrades its homes. The demand for single-family housing units should be stimulated from this source until the mid-1980's. At the same time, there'll probably be a large demand for multiple family units and mobile homes because households under age 30 will increase rapidly. These are people who typically seek inexpensive housing. If you consider how critical construction is to our economy, these long-run signs are reassuring.

Looking at capital spending, we see further improvements. This sector typically lags cyclical changes in the economy. Capital spending declined in mid-'75, when the economy had already turned up. Now, capital spending has bottomed out and shows signs of reviving. The Commerce Department's latest survey of intentions indicates rising capital investment in 1976. It will not be a big increase, if you take this and other surveys literally. But typically actual spending turns out higher than the surveys indicate. Capital goods orders and profits figures suggest the investment sector may not prove so feeble as some analysts predict.

Operating profits, which supply investment stimulus and the funds, recovered very rapidly in late 1975. None of this, of course, guarantees businessmen will rush to buy equipment and erect facilities. With office and retail space in surplus, the rise in total investment spending will more than likely be gradual. But a firm basis has been laid for a capital

sector revival, especially among manufacturers. It should help economic recovery.

The economy will receive additional help from exports, although the trade surplus may diminish as the domestic recovery stimulates more imports.

Lest we forget, this is a Presidential election year, when many of those in office and out usually look with particular favor on extra Federal spending. Some forecasts, quite reasonably, add a political stimulus. Putting all these things together, there is a sound basis for expecting the economy to grow solidly in 1976.

Turning to financial matters, a few words about monetary policy and interest rates may be appropriate. I cannot remember when the Federal Reserve has been more visible nor under such close Congressional review. As you must be aware, the Federal Reserve is now required to share its policy intentions with Congress quarterly. On these occasions, Chairman Burns has said that the Reserve System is determined to follow a moderate expansionary course, with a money-growth target of 5 to 7 1/2 percent. These targets can be debated and probably should be changed if economic conditions turn out differently from those we now perceive. But speaking to you today, sharing the cautious optimism I feel, moderation is the soundest policy. And I, therefore, join in rejecting highly expansionist policies.

Advocates of highly stimulative policies argue the economy has so much slack that inflation is no problem. Adherents also believe

monetary policy can be switched quickly, almost overnight, from ease to restriction. These arguments are appealing. But three important factors make me hesitate. First, inflationary pressures are instilled long before the economy reaches full employment. Inflation exists today despite excessive capacity. Second, the amount of slack in the economy is not the chief determinant of inflation. Domestic inflation can develop from many sources, such as international factors, union bargaining power, government anti-competitive regulations, and corporate pricing policies. Whatever its source, it still counts. Third, persistent shortages in health care, energy, and other specific sectors can add inflation despite the existence of unused industrial capacity elsewhere. We overlook these considerations at our peril. In my view, therefore, too rapid a recovery would inhibit further progress against inflation, bringing us closer to the next recession. After all, the last recession was a reaction to the inflationary buildup preceding it.

Expansive monetary and fiscal policies are not easily reversed and easy credit and fiscal deficits first stimulate output and then affect prices. Expansive Federal policies help the economy initially by stimulating output, but they leave a residue of price pressures which later have to be faced. For these reasons, moderation in our fiscal and monetary policies would serve both the short- and long-term interests of our economy. A sustainable recovery is more important than a quick recovery.

Turning to interest rates, I frequently hear that they depend directly on monetary and fiscal policy. There is a connection. But

this view overlooks the important influence private credit demands have on interest rates. Massive Treasury financing influenced most analysts to predict higher interest rates in 1975. Obviously, they were wrong. Short-term interest rates and corporate bond yields actually declined. They were wrong in giving private short-term credit demands insufficient consideration. Interest rates for 1976 will continue to be influenced by private credit demands. Whether that means interest rates will rise or not, I have not yet reached an opinion. But if inflation kicks back up, then interest rates will almost certainly increase.

What are the prospects for inflation? I see hope, especially in food prices. Record crops are apt to hold food prices down. But even now we see markups in depressed industries where one might expect prices to be going down. Also, in 1976, collective bargaining agreements covering nearly 4.5 million workers expire. This year's bargaining schedule includes the teamsters, construction, and auto workers. A situation exists for potentially long strikes and high wage settlements. If they get hefty wage increases, a labor push-cost spiral could reappear. For as you are aware, when wages grow faster than productivity, labor costs rise.

Productivity increased sharply in the second and third quarters of last year. This usually happens initially during an economic pickup; but later productivity usually levels out. As plants approach full throttle and skilled people become harder to find, costs escalate. So the real battle for productivity lies ahead. Thus, I am worried about productivity

and about the traditional conflict between management and labor over wage demands this year.

There is a newer adversary relationship among government, business, and consumers over pollution, safety, health care, and related subjects. These confrontations sap the confidence needed to vitalize the economy in the long run. If we lack confidence, we may lack enough private spending to keep the economy going. The public is beset with uncertainty. It has lost confidence. So I suggest that full recovery awaits full restoration of confidence.

In this connection, perhaps I should single out the banking system for special comment. Sure, banks--like many other institutions--found their liquidity strained during the last recession. Banks experienced losses, especially on real estate loans. Some will experience further losses. But the vast majority weathered the storm with minor difficulties, and I am happy to report that the liquidity of the banking system has greatly improved, along with the rest of the economy.

Economic growth requires money growth, and whether there will be enough is a subject of wide debate. The enormity of this issue is brought home to all of us by the mere cost it takes to do business today. Modern technology requires investment in new productive capacity. Modern society demands investment for fighting pollution, for safety, and for improving the quality of life. Consumers are not satisfied with what they have. Americans now want air conditioning in their homes and cars. They want their homes to be bigger than five or ten years ago and

to have more bathrooms. People want more and better things, things which cost more and more.

We hear solutions. Tax systems, for instance, can be changed so they do not discourage capital formation. By favoring debt rather than equity financing, our tax system does just that. Interest costs are tax deductible while dividends are not. This is only one area where tax relief is in order.

This country is not rich enough to afford everything. We have to make difficult choices: Scale down our wants, live within our means, guard against price inflation, enable industry to improve its liquidity position and permit credit markets to allocate available funds among competing demands.

Whether we do these or not in 1976 may not matter, since we can be optimistic about the prospects for the year ahead, regardless. But the long-term viability of the economy demands that we become hard-nosed and confront these basic economic problems. If we tackle the fundamentals, we can afford the future.