CURRENT MONETARY AND CREDIT CONDITIONS

Remarks by Mr. Robert P. Mayo, President of the Federal Reserve Bank of Chicago before the 52nd Annual Meeting of the Illinois State Chamber of Commerce, October 2, 1970

I am pleased to have been invited to talk to the members of the Illinois State Chamber of Commerce. Governor Mitchell had very much wanted to be with you today and to greet his many friends and acquaintances in Illinois. But as you know, illness forced him to cancel his appearance. For his many friends here, however, let me add that George is feeling much better and we are all hopeful that he will be back in full-time service shortly.

Substituting for George is not an easy job. He is one of my most articulate and knowledgeable friends of long standing. And as many of you know, he frequently introduces challenging ideas in both his private and public contacts. So it is tough to substitute for him.

In thinking about my remarks for today, it occurred to me that it wouldn't be difficult to be provocative. After all, there are a great number of irritants in today's environment. The economic situation is certainly one of them. The current economic climate may not necessarily provoke you to anger, but it surely is perplexing. Here we are as businessmen and policy makers looking on the one hand for clearer indications of cooling on the price front and yet on the other hand for signs of revival in the pace of economic activity--two developments that don't seem to go together traditionally, since they seem to require what appears to be contradictory policy prescriptions.

We don't even know what to call this economic development. Or at least we didn't know until last week. Now, as you know, the National Bureau of Economic Research, which is in charge of naming such things, has designated this period as a "growth recession"--a name that I have no doubt will continue to elicit comment and discussion for some time to come.

So, appearing before you today to talk about monetary and credit conditions is timely. Markets are going through some interest rate adjustments. Money supply figures and talk of easier monetary conditions are common business lunch conversations, as businessmen try to rationalize the dichotomy of rising prices with a plateau in real economic activity on a nationwide scale. And often the national statistics offer no comfort at all to businessmen in a city or an industry that is indeed in a recession--and there are many such examples today.

Let me add my voice to this discussion, then, and talk with you about some of the factors that explain recent credit and monetary developments.

The year 1970 to date has seen what amounts to an unwinding of monetary restraint. The second half of last year, you will recall, was a term of pronounced monetary tightness. From the middle of 1969 right through until the end of the year, the money stock (defined as demand deposits plus currency in the hands of the public) showed almost no change. This had been preceded by a long term of rather lively growth over the whole period following earlier restraint in 1966.

Since the end of 1969, the total money stock has grown at an annual rate of roughly 5 percent. Since last March, or through the past two quarters, the growth rate has been somewhat greater than this, or on the order of 5 1/2 percent. By historical standards, these are comparatively high rates, but they have been generally consistent with and reflect the widely heralded turn toward easier monetary policy that took place shortly after the first of the year.

Despite the general, if not uninterrupted, decline in interest rates under way in 1970, the past months could hardly be regarded as a term of easy credit, despite the climate of monetary ease. A voracious demand for long term accommodation by corporate borrowers, a vigorous demand for funds on the part of the housing industry and state and local governments--plus frequent trips to the market by the Treasury and the federal agencies--have combined to sustain heavy pressure on overall credit supplies.

The recent decline in the prime rate may be taken as a portent of further softening in interest rates in the closing months of 1970. At the same time the prospect of continued heavy credit demands affords little reason to suppose that any pronounced decline is in the offing for the near term.

The persistence of historically high interest rates is frequently noted as a reflection of the lingering presence of inflationary sentiment and inflationary expectations. It is argued that if borrowers and lenders had become generally convinced by now that the forces making for higher prices--especially in markets for durables, new construction and other long-life assets--had by now largely spent themselves, interest rates today would be appreciably lower than they are. In short, the mark-ups built into the interest rate structure as a hedge against inflation in recent years are still there.

The stubbornness with which inflationary psychology has clung attests to the dimensions of the task that has confronted monetary management--and for that matter, fiscal management--during the whole period since mid-1965, when the defense buildup got started. The continued existence of inflation after an extended application of counter-inflationary policy had left us in the awkward and rather paradoxical position of having to sustain the effort despite the emergence of signs that the policy in terms of wringing out excess demand was succeeding. Few would argue that the job has been accomplished. Prices continue to climb uncomfortably--albeit over the longer pull the rates of advance are moderating. Meanwhile, the pace of economic expansion has slowed.

But consistent with the "growth recession" label, the decline has been mild. Total employment, personal income, industrial production and overall output are all at, or near, all-time highs. Consumer outlays are growing. The fixed investment of business is being "reasonably" well maintained. In fact, the overall economic adjustment since the summer of 1969 has been milder than in any recession since World War II.

Even in comparison with the recession of 1960-61, considered in retrospect to be the mildest of the postwar period, the current adjustment makes only a dent. In 1960-61, industrial production fell almost 6 percent. Current figures indicate that industrial production is off about half that amount to the June low point. Similarly, the decline in total man-hours worked in nonfarm production has remained small in comparison with the 60-61 experience.

But there are also other symptoms consistent with that "growth recession" label. Homebuilding activity has been sharply reduced (although prospects look good for some expansion in the months ahead), defense production had declined, the rate of growth of business capital spending has slowed, automobile production has slackened and importantly, pressures upon the labor force have abated appreciably, with a consequent rise in unemployment.

The upshot is that we appear to be looking anxiously for signs of two things that are generally thought to be antithetical: for one, clearer indications than we have had thus far of cooling on the price front and second, signs of revival in the economy's pace of real activity.

As a rule, a lagging pace of real activity, which spells dwindling pressure on the economy's resources, can be construed as precisely the kind of environment in which to find weakness in the price structure, or at least lessened upward pressure. But an acceleration in the real economy is usually associated with a buildup of price pressures. To put it the other way around, a sustained uptrend in prices is something that we ordinarily expect to find when there are undue pressures on resources, not when there is slack. A sidewise price movement, not to mention an outright downturn, is the sort of thing we used to associate with a widening gap between production potential and production performance.

In the present environment, oddly, the uptrend in prices continues against the backdrop of indications that the economy's performance continues to slip progressively below its output potential. Yet it may be that this state of affairs is not really as paradoxical as it seems at first blush. The reason is that the forces behind any marked and sustained uptrend in prices take a considerable time to develop in the first place and then to spread through the economy.

Consider the sharp expansion in federal expenditures set in motion by the escalation in Viet Nam, heavier human resource spending at home, and the responsive accommodation of the Treasury's needs in the form of monetary expansion. It was not to be expected that these expansionary impulses would subside in short order after the initial impetus. Rather, the expansion touched off effects on income and expenditure that were to manifest themselves over an extended period, right down to and through the present, to judge by historical patterns. Moreover, it was scarcely to be expected that the steps initiated to battle the waves of excessive expansion after mid-1965 would quickly register.

As I have indicated, the sidewise movement in the Nation's money stock, and in bank credit, that characterized the second half of 1969 gave way to renewed growth of these important financial aggregates at the turn of the year. Ever since that time money expansion has continued, at a generally moderate and reasonably steady rate. If the time lag between the initiation of a change in monetary policy and the time of occurrance of the response to that change is on the order of six to nine months--as is suggested by certain of the empirical studies that have been made--the economy ought to be at the watershed at just about the present. Largely for the reasons that I have sketched over here quite briefly, the expectation has become more widespread that the final months of this year and more particularly the first half of next year, will see more evidence of economic buoyancy. By the same token, the avoidance of excessive financial growth during the past three quarters, affords grounds for believing that the inflationary pressures with which we have been grappling are due to lose their strength.

In characterizing the thrust of monetary policy over the recent past, I have placed considerable reliance upon the behavior of money. In doing so I have not intended to suggest that any exclusive preoccupation with this monetary variable is necessarily appropriate as a matter of principle. Important as the money stock is, it constitutes only one variable with which the central bank needs to be concerned.

In good measure, the reason for a somewhat greater concentration on money in the recent past lies in the crosscurrents that have tended to blur the meaning and usefulness of so many of the measures that traditionally concern the Federal Reserve. The behavior of bank credit, for example, is a factor that the monetary authority in due course regards as a crucial indicator of the thrust of its action and of the course of the economy. But, the disintermediation and reintermediation of funds through, first, the shift from commercial bank time certificates of deposit to open market commercial paper, and then back again from the market to the banks, has touched off movements in the volume of bank credit that obviously have had no real significance as an indication of shifts in monetary policy. For much the same reason, the so-called bank credit proxy, which is closely related to the broad definition of the money stock, (M_1 plus time deposits), similarly has been of limited usefulness during the recent past. Finally, the behavior of interest rates alone is an incomplete indicator of the direction of past monetary action or of the direction that it is appropriate for monetary action to take.

This occurs simply because of the feedback effects of credit demand upon the interest rate structure--a set of influences quite apart from those rising out of monetary changes on the side of supply, which presumably is under the direct influences of the Federal Reserve.

A mechanical application of monetary rules is, of course, unrealistic. The Federal Reserve System obviously cannot ignore the sharp shifts in money and credit markets--nor has it. Both open market operations and the discount window were used constructively this year to accommodate credit demands of the banking system. In addition, once it became apparent that some nonbanking firms were having difficulty in refinancing commercial paper, the Board suspended Regulation Q ceilings on large denomination certificates of deposit with maturities of less than 90 days. This enabled banks to obtain funds that investors were hesitant to place in other markets and to rechannel these funds to borrowers previously dependent on commercial paper.

Remember that the economy has experienced some unusual stresses and strains this year. Economic policy has had to walk a tight rope. But it has, I feel, largely done an excellent job.

The task cut out for the Federal Reserve at a time like the present is obviously a delicate one. The price of deviating significantly from a course that is appropriate under the circumstances could be exceedingly high.

Too tight a constraint on financial expansion could mean underuse of our economic potential, widening joblessness, and output and income forever lost. However appealing it may be to tackle inflation even more forthrightly, by tightening up on growth in the money stock or on bank credit--or, conceivably, on interest rates--in order to curtail credit-supported spending the cost of such a move in real terms could be, and, I submit, probably would be excessively high.

But to move the other way, toward greater monetary ease and lower interest rates, out of, say, over concern for the effect of tight credit on housing or on the state and local governments, would all but inevitably set the stage for another bout with inflation sometime later on--and it would likely be sooner rather than later. Responsible monetary management in today's setting means adherence to a path of steady and moderate growth. I believe that performance during the year so far has been consistent with such an objective and I am confident that the Federal Reserve will be able to stay on such a course in the months ahead.

FEDERAL RESERVE BANK OF CHICAGO

Statement for the press

For Release: October 2, 1970 p.m.

Mr. Robert P. Mayo, former Director of the U. S. Bureau of the Budget and now President of the Federal Reserve Bank of Chicago urged today that economic policy continue to follow a moderate course. There will be strong recurring pressures for stronger measures to combat both inflation and a sluggish economy, he said. But we must resist these pressures. Otherwise we are in danger of sliding onto either the inflationary or recessionary shoulders of the road.

Speaking in Chicago before the 52nd Annual Meeting of the Illinois State Chamber of Commerce, Mr. Mayo pointed out that businessmen are looking on the one hand for clearer indications of cooling on the price front and yet on the other hand for signs of revival in economic activity. To many observors, these goals appear to require contradictory policy prescriptions. But, Mayo said, there is only an apparent conflict in policy prescriptions, not a real one.

He argued that the inflationary pressures in the economy are the result of forces set in train some time ago. Price pressures took considerable time to develop and the impulses won't die out over night. It takes time for a policy change to work its way through the economy, Mayo stressed. With the avoidance of excessive financial growth over the recent past, inflationary forces are due to lose strength. There are signs that this is happening, he contended. Too tight a constraint on financial expansion now would have little immediate effect on prices but could impose excessively high costs in joblessness and underuse of economic potential, he pointed out.

Mayo noted, however, that he was not arguing for a substantial easing of economic policy. The moderate course being pursued is in the process of turning the economy around. No one is happy with the level of unemployment we see today, he said. Mayo pointed out that unemployment will probably increase slightly more in coming months but then gradually decline in 1971. Nor should anyone be happy with the present level of corporate profits either, Mayo also noted.

Too heavy a hand on the expansionary throttle would be a mistake; it would inevitably set the stage for another bout of inflation, Mayo said. But, he concluded, there is a middle way--a way that is working--which is consistent with achieving both price stability and high levels of economic activity.