The Road Back: Economic Prospects for 1971

Remarks of Mr. Robert P. Mayo,
President of the Federal Reserve Bank of Chicago
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I thought that I might spend a few minutes talking with you about the economic outlook. Fed officials always have some difficulty in talking about this subject, of course, since we can't look at the future of the economy simply as an exercise in forecasting. The future is influenced by monetary policy and obviously, the Fed's intentions are an important element in any forecast of the future of the economy.

But much can still be said without talking specifically about current or possible future policies. Besides, monetary policy is flexible, it can and is changed as the economic scenario unfolds.

Governor Robertson tells a story about the painter from Broken Bow that I think will give you some idea of how I feel:

> There was a portrait painter who lived in the small town of Broken Bow, Nebraska. He was a good artist and his fame spread far and wide until it reached Omaha. A woman in Omaha decided that she wanted her portrait painted and wrote to the man in Broken Bow. She told him that she would be willing to pay slightly more than his usual fee of $250 because she wanted him to paint her in the nude.
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> The artist wrote back declining the offer on the grounds that he was an extremely moral man and, therefore, he could not paint her in the nude. She

wrote back upping the fee to $500 but he again refused on the grounds that as a well respected member of the community he simply could not paint her in the nude.

But she was persistent and again raised her fee, this time to $1,000. He replied politely, "Madam, I want you to understand that because of my moral views, standing in the community and deep religious feelings that I am most reluctant to paint your portrait in the nude. However, I find your offer of $1,000 impossible to resist. I have one condition however and that is that you allow me to keep on my socks so that I have some place to keep my brushes."

There are, I think two elements of the ~~study~~ story to emphasize. First, when a fed official is invited to speak before a group such as this no one really expects him to divulge everything he knows about the make-up and thrust of current monetary policy. No one is asking him to paint the economic picture in the nude. Secondly, I hope that you will let me keep my socks on so that I have someplace to keep my brushes or my economic policies, if you will.

As you are all aware, in the fall of each year, economists of all persuasions who have lain dormant during the hot summer begin the annual ritual of forecasting business conditions for the coming year. It begins with what might be called the swarming period during which the herd or grouping instincts of the forecasters becomes very strong. The objective is to find that congenial grouping into which they can settle comfortably through the long winter until the herd breaks up the spring.

Before looking at the herd into which I fall, it would be best to review briefly where we are so far in 1970.

Throughout 1970, policy actions of the Fed have been directed toward the encouragement of moderate growth in the supply of money and credit. The record of the past shows clearly that such actions are effective in halting and reversing declines in activity and employment. But the record also shows that the effects of changes in policy are not immediately apparent. Unfortunately, moreover, these "lags" are of uncertain duration.

A number of significant milestones have been passed as the nation makes the difficult transition from a period of inflationary excesses to one of sustainable economic growth. There is some evidence that the downtrend in general activity was halted earlier this year. Very modest increases in total output occurred in the second and third quarters of 1970. This uptrend was halted, temporarily, by the auto strike that idled more than half of the facilities of the nation's largest industry for more than two months. Unemployment continued to rise in the early autumn, but total employment, abstracting from the strike, appeared to be on the uptrend again. In none of the adjustments since World War II, has the economy suffered a basic relapse once a downtrend was reversed. The monetary and fiscal authorities do not wish to see a precedent established in 1971.

Financial stringencies are being alleviated in market after market. Most dramatic has been the renewed vigor of residential construction, always a prime beneficiary of monetary ease. Flows of funds to savings and loan associations and mutual savings banks have increased sharply in recent months. A large share of these funds are being invested in new housing.

Life insurance companies this year have experienced a substantial reduction in the drain of funds to loans to policyholders. Now they are examining opportunities in their normal investment channels more closely.

Many commercial banks have reported a marked drop in loan demand since last September. With ample funds now available, banks are adding to their investment portfolios, especially municipal securities, and are welcoming loan applicants again.

Part of the recent paydown in business loans reflects the application of funds obtained by corporations in the capital markets. Corporate sales of securities in the first nine months amounted to $27 billion, up almost 40 percent from the record volume for the same period established in 1969.

Sales of long-term securities by state and local governments this year also have exceeded sales last year by almost 40 percent. The calendar of prospective new issues remains relatively heavy.

Consumer instalment loans have risen much less this year than last, despite the proliferation of credit card plans and other inducements. Primarily, this reflects reduced sales of automobiles. If the strong revival in auto sales expected next year by industry experts materializes, consumer instalment debt will rise sharply. Higher incomes and paydowns of loans incurred in the past will facilitate expansion of these debts.

The federal government's needs for borrowed funds are much higher this year, mainly because of the shortfall in receipts associated with slower growth of personal income and a decline in corporate profits. In the past two fiscal years, the federal budget had been approximately balanced. It now appears that the federal government will continue to require a large volume of additional funds from the money markets throughout 1971.

In 1969, total funds raised by the nonfinancial sectors, public and private, totaled $88 billion, second only to the record $97 billion raised in 1968. In the third quarter of 1970, total funds raised were at a seasonally adjusted rate of $103 billion, according to preliminary estimates of the staff of the Board of Governors of the Federal Reserve System. The volume raised in the second quarter was almost as large.

Despite the extremely large volume of new security issues, mortgages, and government borrowings, interest rates have drifted down from peaks reached about midyear. The downtrend has been especially significant in the short-term money markets. This, too, is a typical development in a period of easier credit availability. Lenders have continued cautious and selective, however. Interest rates have eased most for the most credit-worthy borrowers.

Financial institutions, business firms, and consumers have been improving their liquidity position in a balance sheet sense this year. But liquidity is not simply a matter of arithmetic. Rather, it is a stage of mind as to the availability of funds in the future, to pay bills--availability from operations as well as borrowings.

Liquidity in the psychological sense was badly shaken twice in recent years--in the third quarter of 1966, and in June of 1970. In each case the Federal Reserve System, the "lender of last resort," took vigorous steps to make certain that a financial crisis of snowballing proportions would not develop. This year actions included suspension of the interest ceilings that banks could pay on short-term certificates of deposit, expansion of open market operations, and assurance that the discount window was open to tide banks wishing to borrow from the Federal Reserve Banks through a period of stringency.

The Federal Reserve System's actions during 1970 should provide convincing evidence that monetary policy is not tied to dogmatic, or mechanical rules, but remains flexible to deal with new problems as they appear.

But now, having already dropped some hints, let me proceed to identify the herd to which I belong. If you accept with me the view that the economy has made a durable change of direction, the key question is how fast the recovery will proceed.

All of the projections I have seen envisage uninterrupted growth through 1971, both in dollars and in real terms. The differences are in the amount of the rise in activity and the degree of moderation in price inflation.

The sections of the economy expected to lead the upturn are residential construction, retail sales (especially of durables) and state and local government expenditures. I would also add inventory investment to the list of plus factors. Capital expenditures will remain sluggish with some classes of equipment such as machine tools, the weakest in several years. Cuts in defense spending are continuing, but by far the largest share of the absolute reduction in dollar outlays has already occurred. Further, it is widely believed that nondefense expenditures of government will rise more than is currently projected officially.

Total corporate profits before taxes, as calculated by the Department of Commerce, hit an all-time peak annual rate of $93.4 billion in the second quarter of 1969. The downtrend continued into the second quarter of 1970. The third quarter rate was up to $85 billion. If for the year, profits amount to $83 million, this will be a year-to-year decline of about 9 percent. This is greater than the drop of 5 percent in 1967 but smaller than the 12 percent decline of 1958 and the 18 percent decline in 1949.

But business firms have moved vigorously to bolster sagging profit margins. Labor hoarding has changed to dishoarding, even to the extent of releasing long service employees. Marginal facilities have been sold or closed. Outlays on advertising, publicity, entertainment, charitable activities and other "nonessentials" have been cut back. Expense accounts have been controlled more closely. Inventories have been reduced and capital expenditures postponed.

Attempts to improve efficiency and reduce nonessential spending have greatly improved profits for many firms. Increased selling prices have also helped profits. But the most important thing for an improved profit picture in 1971 will be improved volume. Mainly because of the importance of fixed or ~~of~~ semi-fixed costs, profits fluctuate much more than sales or GNP. The recent decline in corporate profits for most firms was associated not with a decline in sales but with slower growth. If output and sales move closer to optimum levels next year, profits will rise substantially.

Forecasts of GNP for 1971 range from about $1030 B to $1060 B (5 to 8 percent). The lower forecast would probably be associated with a rise in before tax profits of 8 to 10 percent (to $90 B) and the higher forecast with a rise of 15 to 20 percent (to $97 B). The last year to produce a use in corporate profits of as much as 20 percent was 1965. Increases in profits would probably be accompanied by a rise in stock prices, especially in view of the fact that stock prices currently are more than 20 percent below the levels of late 1968.

A strong rise in stock prices next year would contribute to an improvement in confidence of consumers and investors.

The shock-effect of the 1969-70 business adjustment on consumers, businessmen and investors has been an important factor in depressing spending. When the general revival of business in 1971 becomes clearly established, it is reasonable to assume that many deferred plans will be activated.

But the question that really bothers everyone now is the apparent conflict between rising unemployment and the insufficient cooling of prices pressures. Increases in compensation gained by organized labor have accelerated in the past six months, despite a marked easing in the availability of workers, both inexperienced and those with usable skills.

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. 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 has slipped 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 ~~is~~ 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 ~~impluses~~ 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 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.

The fact remains that in spite of the wiggles and wobbles of the price indices, the inflation rate has declined from the high levels experienced during 1969 and early 1970. I expect to see some further moderation but only to 3 or 4 percent in 1971 as compared to 5 percent on the GNP deflator in 1970.

There are several reasons for my arguing that a further decline of the inflation rate is in the offing. First, the rate of inflation responds to the unemployment rate with a lag so that we have not yet had the full effect of the unemployment rate we have already experienced. Second, even though the unemployment rate should decline in the latter part of 1971, it will remain high for some time and this should exert a retarding effect on wage and price increases.

Finally, we should be entering a period in which productivity--output per man-hour of work--rises with exceptional speed. Gains in output per man-hour for the entire economy were almost nonexistent in 1969 and the first quarter of 1970. With the shake-out of work forces and closings of less efficient facilities productivity began to rise again. Productivity will probably rise substantially next year, perhaps matching, or exceeding, the long-term average gain of almost 3.5 percent. Improved productivity will help to boost profits and hold down price increases.

But there is also another side to this and that is that the rapid productivity advance is likely to be accompanied by a less rapid response from the unemployment rate. I do not mean that we can only get inflation down by abandoning efforts to reduce unemployment nor that we can get the unemployment rate up only by abandoning our efforts to reduce inflation. There is a middle road that we have been following. The major emphasis is on fostering a rapid enough economic expansion to absorb the growing labor force and to make some inroads on the present level of unemployment without setting inflationary fires that will burn out of control in late 1971 or 1972--the problem of lags I alluded to at the outset.

We cannot be like the truck driver.

A truck driver was sitting all by himself at the counter of the Neverclose Restaurant down by the depot.

The waitress had just served him when three swaggering, leather-jacketed motorcyclists--of the Hell's Angels type--rushed in, apparently spoiling for a fight. One grabbed the hamburger off his place; another took a handful of his French fries; and the third picked up his coffee and began to drink it. The trucker did not respond as one might expect. Instead, he calmly rose, picked up his check, walked to the front of the room, put the check and his half-dollar on the cash register, and went out the door. The waitress followed him to put the money in the till and stood watching out the window as he drove off. When she returned, one of the cyclists said to her: "Well, he's not much of a man, is he?" She replied, "Nope. He's not much of a truck driver either--he just ran over three motorcycles!"

The task of responsible monetary management is to assist the economy to get back on a sustainable path of long-term expansion with relatively full employment and reasonable price stability. With appropriate policies then we should see 1971 as a year of moderate expansion in real output, a slowdown in the rate of inflation, and the beginnings of the process of return to full employment--all in all a productive year but with final attainment of our economic goals still somewhat farther off in the future.