1971: Another Year of Transition

Remarks of Mr. Robert P. Mayo
President of the Federal Reserve Bank
of Chicago
at a meeting of the
Economic Club of Chicago
Chicago, Illinois
January 11, 1971

I am pleased to talk with all of you today about the economic prospects for 1971. The nation has been making a difficult transition from a period of inflationary excesses to one of sustainable economic growth. This transition, while hopefully less difficult, will be continuing in 1971. But the controls are not set for automatic re-entry. A public understanding of the issues and the earnest concern and involvement of private decision makers will be required to insure the most appropriate settings.

I am well aware of the difficulties in presenting new and exciting ideas on the economic outlook to a group such as this. The annual ritual of forecasting business conditions has largely been completed and the herds into which economists fall have been selected. Most of the important trends have been examined and re-examined. And these ideas and views have been widely disseminated since the interest of the press and the public in economic affairs has never been more keen.

Nevertheless, I am willing to run the risk of being placed in one of the herds. I am willing to run the risk of re-examining issues already re-examined. In short, I am willing to risk not being very exciting. And I am willing to do so on the grounds that we are talking about extremely important matters.

The 1970 Transition

Throughout 1970, policy actions of the Federal Reserve had 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 shows just as clearly that the effects of changes in policy are not immediately apparent. Unfortunately, moreover, these "lags" are of unpredictable duration.

A number of significant milestones have been passed as the nation has moved along its transitional path. There is some evidence that the downtrend in general activity was halted last 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 production facilities of the nation's largest industry for more than two months. Unemployment continued to rise but total employment, abstracting from the strike, appeared to be on the uptrend again. In none of the economic 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 a less restrictive monetary policy. Flows of funds to savings and loan associations and mutual savings banks have increased sharply in recent months. A large share of these funds goes directly into new housing.

Life insurance companies have seen a substantial reduction in the drain of funds to loans to policyholders. Meanwhile, many commercial banks have reported a marked drop in loan demand. 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 1970 amounted to $38.6 billion, up almost 45 percent from the record volume for the same period established in 1969. Sales of long-term securities by state and local governments last year also exceeded 1969 sales by almost 50 percent.

Consumer instalment loans rose much less rapidly last year, 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 this year by industry experts materializes, consumer instalment debt should 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 budget receipts associated with slower growth of personal income and a decline in corporate profits. For the past two fiscal years, put together, 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 had risen to a seasonally-adjusted annual rate of $103 billion. The fourth quarter will probably show a comparable level.

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

Financial institutions, business firms, and consumers have been improving their liquidity position in a balance sheet sense. But liquidity is not simply a matter of arithmetic. Rather, it is a state 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 again this last June. In each case the Federal Reserve System, the so-called "lender of last resort," took vigorous steps to make certain that a financial crisis of snowballing proportions would not develop. Actions taken 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 assist 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.

Transition Pace in 1971

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 for 1971 envisage fairly uninterrupted growth, 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 of durables and state and local government expenditures. I would also add inventory investment to the list of plus factors. Capital expenditures may remain sluggish with some classes of equipment such as machine tools, on the weak side, although the Treasury's anticipated liberalized depreciation guidelines should be very helpful in pepping up this vital sector of our economy. Cuts in defense spending are continuing, but by far the largest share of the absolute reduction in dollar outlays has already occurred. Further, there is no question that nondefense expenditures of government will rise more than is projected officially for fiscal 1971, and that 1972 will see very substantial increases--largely in so-called "uncontrollable" expenses such as benefit payments.

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 billion, the year-to-year decline will have been about 9 percent. This is greater than the drop of 5 percent in 1967, but smaller than either 12 percent decline of 1958 or 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, and charitable activities 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 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 more closely to optimum levels next year, profits will rise substantially.

Increases in profits could very well be accompanied by a further rise in stock prices--a rise which would contribute significantly 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 plans on the shelf will be activated.

But the question that really bothers everyone now is the apparent conflict between rising unemployment and the insufficient cooling of price 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 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 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. Further, 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 <u>has</u> declined from the high levels experienced during 1969 and early 1970. I expect to see some further moderation in 1971--perhaps to 3 or 4 percent 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 underutilization of resources with a lag so that we have not yet seen the full effect of our policies. Second, even though the unemployment rate hopefully will start to decline by 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--will rise. Gains in output per man-hour for the entire economy were almost nonexistent in 1969 and during 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 this year--perhaps matching, or exceeding, the long-term average gain of almost 3.5 percent. Improved productivity will help to boost sagging profits as well as to hold down price increases.

But there is also another side to this. 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 both the Administration and the Federal Reserve 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 turn fiercely again in late 1971 or 1972--the problem of lags I alluded to at the outset.

Balance of Payments in 1971

At this point I would like to turn to an assessment of developments in an area that is not usually a part of the traditional beginningof-the-year crystal ball gazing--this country's international balance of payments position. I suspect the reason why an economic outlook in this area seldom finds its way on the agenda of the fellow prognosticators is two fold: First, I suspect that those who tried it at one time or another in the past have invariably found that their credibility as forecasters had suffered long-term damage as a result of the rapidly changing international political, military and economic scene--and its largely unpredictable impact on this country's balance-of-payments position.

I, too, am aware of the "thin ice" on which I am about to step in this respect.

The second reason for the traditional reluctance of forecasters to tackle the balance-of-payments issue appears to be that on net balance the foreign sector represents only a very small portion of the total economic activity of our nation. Therefore, it is argued one need not be much concerned about what has or will happen to our balance of payments. It is my deeply felt disagreement with this second premise that forces me to take the step (or the plunge if you wish) in discussing the balance of payments outlook.

Let me explain why I feel this premise has been wrong and why it is particularly wrong at this time.

Since 1945, the U. S. dollar has occupied a special place among world's currencies. The dollar has been the nucleus around which the monetary system of the free world has been built. As such, the dollar has been the vehicle of economic reconstruction of Europe, it has been, and continued to be, the medium that aided the growth of world's commerce and the prosperity and economic well-being of virtually all nations of the free world have been largely dependent on it.

As a nation, we have eagerly participated in formal programs that aided these developments. The billions of dollars that we have given the world in the form of foreign aid attest, in part, to our recognition of our responsibilities as a member of this great family of nations. But what we sometimes forget is the fact that our contribution has not been confined to the extension of foreign aid. Indeed, of far greater importance in these developments has been and will continue to be, in my judgment, the contribution that we as a nation can make by making sure that the dollar--the international medium of exchange and store of value--remains sound. For, the health of the international economic system rests on a sound dollar in its role as international money just as surely as the health of our domestic economy rests on a sound dollar in its role as our domestic money. And in the final analysis, in a world closely tied together by a vast network of trade and financial relationships, where our own security and economic well being is intertwined with that of the rest of the world, a viable international monetary system is essential for achievement of our own domestic goals, as it is for other nations.

In the international monetary system as presently constituted, the strength of the dollar abroad is closely linked to the flow of dollars to and from this country. These flows are reflected in our balance-of-payments statistics. They are the gauge of our performance in discharging our responsibilities. Therefore, they must be, I believe, an integral part of the backdrop for assessment of our economic performance and prospects.

I need not stress to this audience that the readings we have been getting from this thermometer over the past number of years have not been entirely satisfactory. Despite various measures taken to improve our balance-of-payments performance, our international books have continued deeply in the red. 1970 was no exception. It now appears that we will have ended the year with a deficit on the so-called liquidity basis of about $3.0 billion, and with a deficit on the official transaction basis of perhaps close to $8.0 billion.

In trying to assess the future, we must look at some major individual components of the overall measures. First, and foremost, the developments in our trade account have been of particular importance in our balance-of-payments picture. We have relied on the surplus that this account usually generated to finance, so to speak, our traditional deficit on the capital account. During the first half of 1970, the trade account showed some very encouraging signs of improvement after the dismal performance of the preceding two years. Our exports, stimulated by the continuation of boom conditions abroad, advanced briskly despite the rather unfavorable cost-price developments at home. The growth of imports, that in the past two or three years had been the main culprit in our deteriorating trade surplus, moderated in the wake of the slow-down in the U. S. economy. As a result, by the midyear, our trade surplus ran at a rate of well over $3 billion. In the second half, however, particularly in the closing months of the year, the trade account began to show some renewed signs of weakness. Whether these signs can be taken as a portend of things to come in 1971 remains to be seen. Some casual observations point in that direction: expectations of less buoyant demand conditions abroad, combined with the expected strengthening of demand conditions at home simply do not add up to an expectation of continued growth in our trade surplus in the immediate future. In the longer run, much will depend on our ability to contain inflationary pressures that have not only been affecting our competitive position in the world markets, but have also been the main cause of the sharp increases in our imports during that period.

In the capital account of our balance of payments, the outlook is rather mixed. On one hand, there are strong indications that we will again see in the coming year a sizable inflow of foreign capital in the form of foreign purchases of U. S. securities. Such an inflow was an important positive factor in our balance of payments in 1968 and part of 1969.

But these are also some potentially unfavorable developments looming on the horizon in our capital account. A survey of U. S. corporations operating abroad indicates that it is their intention to step up their investment in foreign plants and equipments, at least during the first half of 1971. Similarly, with the easing monetary conditions in this country we have witnessed some increase in banks' foreign lending activities. A Federal Reserve survey indicates that banks intend to continue their increased activities in this area in the months to come.

I have only touched upon a few points of our balance-of-payments picture. They are, however, the points that will, I believe, play an important role in the unfolding of the balance-of-payments prospects in 1971. What do they add up to? Unfortunately, the sum invariably falls short of what would appear appropriate in light of the importance that, as I have indicated before, I attach to our balance-of-payments performance.

What can be done about this? There is no ready, clear-cut answer to this problem. Dealing with the balance-of-payments problem in the coming year will require imaginative use of the traditional monetary and fiscal policy tools as well as an intensification of the search for appropriate new measures. I stress the word "imaginative." For, in the usage of traditional tools, just as I disagree with those who tend to discount the importance of the balance-of-payments objectives in our overall economic policy formulation, I equally oppose those who would make the domestic goals subservient to balance-of-payments consideration. We must seek a proper balance in the deployment of our tools in striving toward the goals of full employment and price stability in our economy--and an equilibrium in our international accounts.

Given the apparent divergence of these goals at this time, the progress toward achieving all of them jointly--as indeed we must--will be slow, probably much slower than if we focused on achieving any one of them individually. That is why I feel that the traditional tools available to us in dealing with our balance-of-payments problem must be supplemented by special effort to find new avenues for improvement. For example, in our trade relationships with the world at large, we can use our legitimate grievances on discrimination against our goods abroad <u>not</u> as a rationale for our imposition of trade restrictions, but as a leverage for pressing more vigorously for an easing of such restriction abroad and thereby achieving improvement in our trade balance.

In the meantime, however, the problem of the balance of payments will be with us--and pose a continuing challenge for its solution. The development of appropriate policies to insure that in 1971 we will also see an expansion of real output, a slowdown in the rate of inflation, and the beginnings of the return to full employment will be no less a challenge. Let us hope that we will all rise to the challenge!