Fiscal and Monetary Developments
for the Balance of 1971

Remarks of Mr. Robert P. Mayo
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of Chicago
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In his invitation to me, Mr. Little indicated that the theme of your meetings for this year was "Managing Change." I could not have hoped for a more relevant theme for my remarks this evening. Managing change is what economic policy has been all about over the past two years--managing the change from an economy of stubborn inflationary excesses to one of greater stability in prices and employment with healthy, sustainable growth.

It hasn't been an easy job to manage this change. And the job of managing it is far from over. But given the management tools available to us we have, I think, taken the essential steps needed for success.

This is a huge and complex economy. Public and quasi-public officials alike manage within the appropriate constraint that we must not only maintain but help to revitalize the free economic society of which we are so justifiably proud. So managing change for our economy does not mean authoritative directions. It means management to accomplish the changes desired by millions of decision makers.

As a result, the slowness of change is frequently disturbing to some. Economic policymakers are typically criticized for failing to move far enough and fast enough. We have certainly seen ample evidence of this over the last year or so.

But economic management is succeeding in its objective of reaching sustainable economic growth for this country. We are continuing to manage with that change clearly in mind, even though it is taking longer than many of us foresaw two years ago.

With the first quarter of the new year now behind us, the signs continue to point to an economy in the recovery phase. I would certainly agree that there is little evidence of a vigorous business upturn. And I admit that prices are still rising. But the forces for recovery and for some cooling of price increases have been set in motion. We are seeing progress on both fronts.

Too much unemployment, too many unused facilities and an uneasy feeling that inflation really hasn't been licked are causing some to say that we have to rethink our basic position. I don't see that anything as drastic as might be implied by "rethinking our position" is required.

The pace of monetary and credit growth over the past year has been large enough to restore most of the economy's lost liquidity. Our policies have established a sound foundation for the growth of real output at a rate consistent with holding onto and enlarging the gains we've made in restraining inflationary pressures.

What will be necessary for managing change over the rest of this year--the kinds of fiscal and monetary developments in store for us--is suggested by the foundation that has already been laid. As you know, there were some significant distortions of credit flows in 1969 as we moved to a period of pronounced fiscal and monetary tightness. These distortions were largely corrected in 1970. In 1969, commercial banks supplied only about one-seventh of the total funds advanced in the economy--far below their historic share. But in 1970, banks supplied about one-third of the funds advanced. Nonfinancial businesses, households and state and local governments supplied a whopping 44 percent of total funds in 1969 but only 8 percent in 1970.

Commercial banks were able to play an expanded role as a source of funds in 1970 only because of the immense increase in their resources. As measured by the net increases in their deposits and other liabilities, these resources rose by nearly $40 billion last year, compared with $18 billion in 1969. While the rise in demand deposits was about the same in both years, the dissimilarity in increases in time deposits was tremendous. In 1969, commercial banks lost almost $10 billion in time deposits, but in 1970, bank time deposits vaulted by $38 billion, with $15 billion of the increase going into certificates of deposits--the instrument that had born the brunt of the 1969 outflow. What happened was that in 1970 interest rates offered by banks (particularly on CDs with maturities of less than 90 days--after ceilings were suspended at midyear) again became competitive with rapidly declining market yields, and banks gained funds. The sharp turnaround in deposit flows is an accurate barometer of the contrasting posture of monetary policy in the two years.

Bank assets grew by $42 billion last year, twice the amount for 1969. But unlike 1969, when banks liquidated $9 1/2 billion of U. S. Government securities and funneled the money into loans, in 1970 a vast majority of bank funds went into investments: a $20 billion expansion in investments and a modest $5 billion increase in loans. Commercial banks also did something else with their newly found resources last year. They reduced liabilities to their foreign branches by $6 billion. These liabilities mainly Eurodollar borrowings, increased by $7 billion in 1969 during the period when U. S. banks were out beating the bushes in a search for funds to expand loans as domestic deposits shrank almost daily. The extent of these borrowings is made startlingly clear when we realize they accounted for nearly 40 percent of the net increase in bank liabilities in 1969.

What all of this tells us, really, is that commercial banks today are in a much better position to meet the financial needs of our economy than they were just a few months ago--and without any radical revisions in national monetary policies.

If monetary conditions are favorable, how does the economy appear to be stacking up for the year? As you know, the majority of the forecasts are for moderate expansion in 1971. The so-called consensus forecast rounds off at $1,050 billion GNP. And I'm sure everyone here has heard of the Administration's $1,065 billion GNP target.

Most economists feel the official target is very optimistic as a forecast. It certainly is too optimistic if its achievement is forced through increased budget spending and overly easy credit availability--inflationary steps we would surely regret later on. And yet we cannot say that the Administration's target is outside the range of our experience with postwar recoveries in general. It isn't. In fact, what is striking is that even the optimistic goal implies a relatively sluggish performance of our economy compared with past recoveries. Even a cursory review of past cycles indicates that this is a different business cycle.

By all measures, the 1969-70 recession was the mildest of the postwar recessions. The decline in real output from its peak in the third quarter of 1969 to its 1970 low was not large compared with the magnitude of the earlier contractions. The duration of decline--a low in the second quarter after the peak--was comparable to that for the 1948-49 and 1957-58 recessions, but the decline in percentage terms was half of that for 1948-49 and a quarter of the 1957-58 decline.

Shallow it may be, but the 1969-70 recession is the most stubborn we have encountered. If we assume that the first quarter of 1971 has shown a fairly hefty increase in output as auto production resumed and steel strike hedge buying increased, we may have recovered by now to the third quarter 1969 peak. This is a six-quarter span to reach the former peak. All of the postwar recessions except for 1953-54 have shown quicker recovery to the former peak. But even realization of the optimistic administration forecast for 1971 would make the current cycle the most stubborn of the postwar period, with 1953-54 (after the Korean War) as the runner-up.

There is little question that the deterioration of psychology in 1970, following the euphoria of the long inflationary boom of the late-Sixties, must be given heavy weight in explaining the present low profile of recovery. The balloon of endless expansion inflated in the 1965-68 period burst. The drop in the stock market, the Penn Central failure, defense spending cutback repercussions and problems in the securities business didn't add to confidence. Concern about income prospects even by individuals who previously had thought themselves immune to economic downturns, concern about inflation, anti-consumerism and disenchantment with the ultimate goals and structure of the society have all weakened consumer demands on a broad front.

Buffeted by both economic and noneconomic forces, uncertain consumers and investors have altered their patterns of spending and investment decisions. To a large extent the changed psychology and attitudes are not adequately incorporated in either our econometric or our judgmental models. As a result, our projections may be faulty--or at least more uncertain than usual. Approaches to forecasting rely on a comparability of experience, a similarity of response that permits us to judge the effect of the underlying forces. But when our experience is new, when there are no real good measures for so many factors, projections of the future course become more varied and uncertain. Recall, for example, how long you have been hearing that the consumer is the key to economic recovery. He is. He has the income, the savings, the liquid assets and readily available consumer credit. The potential to spend is large. But everyone is having great difficulty in projecting when he will get his hands out of his pockets.

But what is even more unusual about the current recovery is the behavior of prices and labor costs. There are striking differences here that give this cycle its peculiar character. The GNP price deflator has not always had the upward bias of recent years during recessions. It declined 2.8 percent from a high in the third quarter of 1948 to a low in the first quarter of 1950 before starting upward sharply in the Korean War. Average prices did not decline in the 1953-54 recession, but the price deflator was stable from the fourth quarter of 1952 to the fourth quarter of 1953. The price deflator rose through the 1957-58 recession, a development that caused much concern at the time. Price inflation continued in the 1960-61 recession, but at a reduced rate. The acceleration of price inflation in the 1969-70 downturn was, however, a unique development--or at best, a distinct worsening of the trend of a stubborn upward price bias.

Labor cost per unit of output in manufacturing declined significantly in 1950-51, 1954-55, 1958-59 and in 1961 after activity started to recover. The acceleration in labor cost increases in 1970 was unprecedented. Productivity gains were small or nonexistent in 1969-70. A large increase is expected in 1971. But even an increase of 4 to 5 percent (with a long-term average of about 3.5 percent) would fall far short of average increases in worker compensation that now range from 6 to 15 percent per year.

Where does this examination leave us? Clearly we are talking about a different kind of a business cycle. In broad terms we are viewing a cycle composed of a mild decline in output with an inordinately slow recovery constrained by adverse price and labor cost developments. Obviously this pattern has and will continue to influence our economic policies. We cannot react as though we were faced with a traditional cycle.

I have no basis for disagreeing at this juncture with the view that the expansion will be moderate. Developments, for example, in the consumer and business areas may prove me incorrect if confidence is rejuvenated much more rapidly than now seems likely. I would be happy to be shown wrong on these grounds--but most unhappy to be proved wrong because we moved to higher figures because of short-sighted highly stimulative economic policies. This is the kind of cycle in which more expansive monetary actions now will buy us little or nothing in the way of increased real output in the near term but will buy us much in the way of inflation troubles in the longer run.

The easier monetary policies that have been pursued during the past year have not yet accomplished their purpose. The fact that there are lags between monetary policy actions and their effects is well known. The lags apparently are even longer this time. To my knowledge, there is no such thing as "instant" monetary policy. But disappointment with the results of monetary policy thus far must not lead to incautious excesses that may be harmful rather than beneficial to economic recovery. The available funds are there today.

Federal Reserve credit has increased over the past 12 months at a substantial pace. The rate of change in the narrowly defined money stock (currency and demand deposits)--frequently used as a symbol of the overall thrust of monetary policy--expanded in the past year by 6 percent--a rate of expansion well above the average of about 3 to 3 1/2 percent over the last 20 years. This rate of growth has been exceeded very few times and then in only years of intense inflation. However, with unusual liquidity needs and the sluggishness of the economy, a 6 percent rate of monetary expansion thus far seems quite appropriate.

The recent pace of monetary expansion has been accompanied by a significant decline in rates. The rate on three-month Treasury bills, the nearest market approximation to a "pure" interest rate, was at an all time high of 8 percent at the start of 1970. Currently, the bill rate is below 4 percent. The drop in the federal funds rate--the rate banks pay to borrow each other's excess reserves--was even sharper; from 9 percent to 4 percent. Yields on new issues of high-grade corporate bonds declined from a high of more than 9 percent in 1970 to about 6 3/4 percent in late January and around 7 1/4 percent now--a remarkable drop considering the record volume of new corporate bonds floated in recent months.

The spread between short- and long-term rates remains very large. And the spread between U. S. and foreign interest rates is also large--with the result that short-term capital flows abroad have accelerated. In one form this is represented by repayment by U. S. banks of Eurodollars obtained through their foreign branches. With the continuing decline of interest rates in this country, many banks decided the differential in that cost of funds was too large. As a result, Eurodollar liabilities were paid down so that, as of March 1971 outstanding amounts owed by U. S. banks to foreign branches totaled $3 billion compared to $14 1/2 billion in January 1970.

What happens to these outflows of short-term capital? They become reserves in foreign central banks, and the U. S. balance-of-payments deficit, measured on the official transaction basis, grows accordingly. In 1970, this deficit amounted to $10.7 billion, and the decline in liabilities to foreign central banks, including branches of U. S. banks, accounted for three-fifths of this total. On the whole, foreign central banks have indicated they are willing to hold a large amount of dollars in their international reserves. But it is unrealistic to assume they will watch their dollar holdings grow so rapidly without some pressure to turn excess dollars into assets such as gold, or special drawing rights from the International Monetary Fund. In the months ahead, these developments will undoubtedly continue to be watched carefully by our economic decision makers.

What seems to be making the current business cycle particularly resistant to a faster rate of economic growth is that both business and consumers seem reluctant to step up their rate of spending for goods and services. This is the key to increased production, rising employment and more efficient use of plant capacity. But consumers are pessimistic about future employment prospects and real control of inflation. Businesses are caught in a profit squeeze, and are faced with excess plant capacity. They see very little reason to increase spending on new plant and equipment further than they are now doing.

If sluggish output and high unemployment should persist it might be necessary to give additional consideration to fiscal policy. Recent Congressional actions are tending in this direction. The 10 percent boost in Social Security benefits and the simultaneous postponing for a year of an increase in payroll taxes to finance them should increase disposable personal income by $1.4 billion this year and reduce business costs somewhat. Further, if the personal federal income tax exemptions and standard deductions scheduled to increase in 1972 were to become effective in 1971, an additional $2 1/2 billion in consumer income might be realized this year.

Other plans have been put forward to improve the rate of fixed investment. The move to liberalize depreciation guidelines for business equipment will yield a stimulus of about $3 billion in 1970. If Congress should act to restore the investment tax credit that was repealed two years ago, the short-run result on after-tax profits--and therefore, on funds available for investment--might be around $2 1/2 billion. In addition, we are getting closer to an incomes policy which should have some restraining effect on wages and prices, as a supplement to--not a substitute for--fiscal and monetary policies.

Whatever steps are taken, and whatever instruments are employed in the months ahead, must not be allowed to threaten our long-run objective of sound economic growth consistent with reasonable price stability. With appropriate monetary and fiscal policies working harmoniously together--and with responsible union and management policies in industry--there is every reason to believe we can continue to "manage change" effectively.