Financial Resource Planning

Remarks of Mr. Robert P. Mayo
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of Chicago
at the 21st Annual International Conference
of the Planning Executives Institute
Chicago, Illinois
May 25, 1971

It is usually considered proper for a speaker to recognize in his opening statement the importance of the subject matter of the Conference. I want to make such an opening statement about "planning" this morning, but not as a matter of etiquette nor as a perfunctory remark. I think I have earned the right to say I have had long experience with the planning process both in a formal and in an informal sense--experience in both private firms and public service. It is an essential and critical activity--an activity that requires the best of human talents. It deserves the time, attention and concern of everyone in private and public life.

The highpoint in my experience with planning was, of course, my tour as Director of the Bureau of the Budget. Now I don't want to tangle horns with the planning intellectuals who argue whether or not budgeting is planning or planning is budgeting. At the Federal Government level the budget is the financial plan which the President submits annually to the Congress. As a financial plan the budget is concerned with the aspects I consider absolutely essential to a planning function at the Federal level--the determination of national priorities (objectives) and the appropriate allocation of resources to meet these priorities or objectives.

This is planning on a huge scale and planning with a grand challenge --to try to influence Federal spending so as to insure that resources will be available to meet the needs of the future. It is planning which also runs the frightening risk of creating the impressions that somebody down in Washington thinks he is smart enough to make all the decisions that seem to go with the planning function. Fortunately, no one thinks he's that smart, and even if he did, the President and the Congress would pin his ears back pretty quickly.

Nowhere was this concern with effective resource planning more evident than in the Federal budget for the 1971 fiscal year. That budget made a break with tradition by taking a comprehensive and systematic look at the future--well beyond the usual 17 months to the end of a new fiscal year. Long-range projections of Government finances had not been published in the budget before. I am glad to have played a role in that innovation. Such projections are an essential part of an enlightened discussion of public policies, even though precise figures are not possible and would be misleading in any event.

Now that I have left Washington, my appreciation for planning is no less keen and my ability to provide precise figures no greater, but I can still raise some issues for discussion and hopefully add a little to the potential for enlightened review of public issues.

It is clear from the organization of the Conference program that the sessions this morning on the environment are designed largely to provide additional information to you on the future--background which in Mr. Scott's terms will aid in "the determination of desired objectives in the context of that future." In other words you want the "exogenous" information that will serve as background for your planning process.

I don't know how much of what I will say today will be "exogenous." For the short-term future, it probably will be exogenous because the economic train has already been set in motion--there is probably little that you as businessmen can do to change the economic environment facing you over the next few months. But over the longer-term you will affect the economic environment. The longer the term the more endogenous it becomes. Individually the impact may be imperceptible, but collectively your decisions--translated into business and political actions--will shape the economic environment.

Now I suppose I could be accused of providing myself with an "easy out"--of eliminating my assessment of the future by tossing it back on the grounds "that it is up to you." But I don't intend to relinquish this podium so easily. I do want to talk about the financial environment today and the possibilities and problems for the future.

As you know, there are two basic approaches that planners use. The first is to take as a point of departure where you are now, examine how you got there, and project from there. The other approach, considered by some to be more imaginative, is to ask where you want to be 10 or 20 years from now and then work back to the present.

I am intrigued by the more imaginative approach. We are trying to make more use of it within the Federal Reserve System. But for our purposes here I think that a simple statement of our long-term policy goals--greater stability in prices and employment with healthy, sustainable economic growth--will suffice. Keeping these objectives in mind, we can focus, first, on where we are and how we got there as a prelude to where we may be going.

The Current Environment

We are today faced with an economy in which over 6 percent of our labor force is unemployed and less than 80 percent of our productive capital is being utilized. These are the earmarks of an under-utilization of our human and capital resources. This is a period in which we would normally expect to see downward pressure on prices resulting from "excess supply." But we are still being buffeted by price increases--although the rate of advance is slowing. In addition we have recently been confronted with increased international currency worries.

All of this suggests a rather difficult situation. It is difficult, but I am optimistic and growing more so. It has not been easy to manage the change from inflationary excesses to greater stability in prices and return employment. The job is difficult, in part, because the lags in policy effects are long. And because they are long, planning is essential. No objective student of the economy can fail to be impressed with the fact that the economic problems of the last few years are the inexorable product of the fiscal and monetary policies of 1966, 1967 and 1968. The need to take a longer look ahead is clear. Criticism of current policy as being neither large enough or fast enough in turning the economy around fails to comprehend the lesson we should have learned from earlier periods of excesses.

I am convinced that the evidence is accumulating that economic recovery is underway. Consumers are spending a little more freely, residential construction is vigorous and many firms are reporting an increase in new orders. Admittedly, the upturn is not dramatic,but the forces for both continued recovery and a cooling of prices have been set in motion.

As far as monetary policy is concerned, it is clear that the pace of the growth in money and credit in the past year has been large enough to restore most of the economy's lost liquidity. The turn-around in financial flows has been striking. How striking can perhaps be best illustrated in a brief review of our financial experience since 1969.

<u>Tightening credit in 1969</u>

1969 was a year of considerable credit tightening, the record-high interest rates in both the short and the long end of financial markets growing, in part, out of vigorous fiscal and monetary restraint led to a substantial net outflow of deposits from commercial banks, mutual savings banks and savings and loan associations, and a sharp rise in policy loans of life insurance companies.

The high and rising rates that characterized 1969 could be attributed to both supply and demand conditions. On the supply side, the Federal Reserve followed a restrictive monetary stance--increasing the money supply at an annual rate of only 3 percent (none at all in the second half of the year) as compared to the 7.6 percent rate of increase in 1967-68. At the same time, the demand for credit by corporations, municipalities and Federal agencies was especially high.

Through much of the year, the interest rates offered on time and savings deposits, though at the Regulation Q ceiling, were not high enough to compete with the money and capital markets. Hence, private domestic nonfinancial investors (state and local governments, households and businesses) shifted their funds out of the financial intermediaries (both bank and nonbank) and into the higher-yielding securities being offered in the open market--disintermediation, as we call it.

Banks responded to the combination of strong demand for loans and the drying up of deposits by selling government securities to obtain the funds necessary to make more bank loans. Even then, banks were forced to adopt more stringent lending criteria so as to ration what funds they did have available to lend.

The high interest rates also had a considerable restrictive influence upon municipal financing. In many instances market rates exceeded low legal interest ceilings, thereby forcing the state and local governments to postpone or cancel borrowing and spending programs.

Easing credit in 1970

In 1970, credit flows returned to their more traditional patterns as funds flowed back into the financial intermediaries from the open market--reintermediation. A key factor was the receding of interest rates --especially short-term rates. Another contributing factor was the raising of the legal ceiling on large time and savings deposits by the Federal Reserve Board in January. It was not until March, however, that market rates fell sufficiently to allow banks to issue large denomination time certificates of deposit in substantial volume. Once deposits started to flow back into banks, more than one-half of the total volume of savings and time deposits lost in 1969 was regained by April 1970. The decline in market rates gave a substantial boost to deposits for nonbank financial intermediaries as well as for commercial banks.

An example of the shift in financing from the intermediation of 1970 can be seen by comparing the proportion of total funds supplied by banks with that supplied by private nonfinancial domestic investors. Between 1969 and 1970, the banks' share of total funds raised in the economy increased from 14 percent to 33 percent while the private nonfinancial domestic sources share fell from over 40 percent to about 8 percent of the total.

1970 was a year of uncertainty for businesses and households regarding future economic and financial conditions. Hence, businesses, households and financial intermediaries spent much of the year building up liquidity. This buildup could also be attributed to declining market yields as well as uncertain conditions. Consumers uncertainty was reflected both in the high rate of savings (which were primarily channeled into financial intermediaries) and in a substantially improved base for consumer credit and home mortgage expansion.

While banks were receiving a steady inflow of time and savings deposits during 1970, they faced a steady decline in demand for bank loans. Therefore, they used much of the increase in funds to repay Euro-dollar borrowings and to build up their portfolio of government securities --both Federal and state and local.

Corporations were also interested in repairing their liquidity positions and thus spent much of the year lengthening their debt to improve their ratios of short-term assets to short-term liabilities. Hence, they reduced indebtedness to banks by shifting to long-term financing in the capital market.

On the demand side, there was a general decline in the demand for funds; total funds raised by the nonfinancial sector--excluding the Federal Government--fell by 12 percent. Households and businesses were responsible for much of the decline. Households, for example, not only cut back their demand for credit but also shifted their funds out of securities. They reacted to the growing uncertainty regarding economic conditions by acquiring liquid assets of determinable value.

There was a very substantial increase in the demand for funds by state and local governments, which raised 45 percent more funds in 1970 than in 1969. Some of this increase could be attributed to the sale of securities postponed in 1969. These governments took advantage of the declining rates in 1970 to increase their share of total funds raised from 9 percent in 1969 to 15 percent in 1970. Nevertheless, it has been estimated that even in 1970, interest rates were still high enough to choke off 40 percent of the financing desired by state and local governments.

Short-term interest rates experienced a considerable decline in 1970 reflecting both the increased demand for short-term assets for liquidity purposes and the shift, by businesses, to the corporate securities market to lengthen their debt.

Liquidity build-up continues in 1971

Heavy re-intermediation and very strong credit flows, especially in the long-term markets, have continued into this year. Municipal securities have been an outstanding example of the heavy flows--some $6.7 billion in gross proceeds in the first quarter after a whopping $5.9 billion in the fourth quarter of last year.

New corporate bond issues have been nothing short of phenomenal. Few observers expected the 4th quarter $12 billion in new issues, let alone the further rise in the first quarter of this year. These bond issues are partly a substitute for bank credit and other short-term sources of funds. But since the proceeds exceeded current financing requirements there also has been increased growth in corporate liquid asset holdings.

And the build-up continues at banks and thrift institutions. Member bank deposits increased in the first quarter at a 17 percent annual rate--up from the 12 percent advance in 1970. Thrift institutions posted a tremendous 23 percent annual rate increase for the first quarter--three times the rate for 1970.

Outlook for the balance of 1971

Banks, thrift institutions, corporations and consumers are all in a good liquidity position right now. It is indeed easy to argue that the stage has been set for vigorous recovery.

But most forecasts for 1971 are still in the $1050 billion GNP range--give or take $5 billion. Such forecasts are not an indicator of an overly expansive economy. Few accept the more optimistic Government $1065 billion target. Most argue that it can't be reached without overly easy credit--a step we would surely regret later on.

Why is the less vigorous path suggested? We must remember first that there is no perfect relationship between liquidity and spending.

Liquidity is largely a state of mind. The shock to confidence in this downturn has been more severe than at any other time in the post-war period. Confidence will be rejuvenated as the economy picks up. But we can expect some lags this time since the current situation has no exact parallel with the past. The behavior of prices and labor costs are a source of uncertainty and concern. Few doubt that these attitudes will change rapidly.

Short-term planning

For the near term, planners can be confident of the availability of adequate financial resources. And they can,with some confidence, expect the continued recovery of economic activity along a broad front. There is no doubt in my mind that the monetary authorities will strive to maintain credit flows adequate for the recovery which is now underway. But this does not mean incautious excesses. We are well aware of the lags. In our own planning we are quite cognizant of the effects of current decisions on the future position of the economy.

Longer-term planning

While the environment in the short term seems relatively easy to block out, the longer-term picture is increasingly difficult to discern. There are, I feel, some areas in which the public debate is far from finished--areas which are still endogenous to your planning as an individual or political being if not endogenous to your professional planning activity.

The first of these concerns the extent of our public commitment to sectoral goals in our economic policy formulation and execution. Reliance in earlier years on a restraining monetary policy has resulted in reduced credit availability and higher interest rates with more pronounced effects on housing and the mortgage markets than on other sectors of the economy. When we again reach full employment of our resources, will economic policy be constrained so as not to harm housing? But if housing is shielded from monetary restraint, will pressures mount for other sectors to receive similar treatment? How about exports? After-all, we are all very much concerned with our worsening balance of payments trends. Yet to show favor for export financing during a period of monetary restraint could easily force even greater restraint on areas not so favored.

We have many priorities as a people. For example, concern with the quality of life might argue for a more extensive commitment of both public and private resources establishing priorities both for the traditional sectoral goals and for what we may call the "human goals" will be exceedingly important. They will involve hard choices. We will be confronted with a new version of the old phraseology as to whether it is "guns and butter" or "guns or butter."

This leads me to ask the extent of our public commitment to a noninflationary economy. Are we willing as a people, and I think we should be, to make these difficult choices in such a way as not to demand more than our resources will allow? Or are we going to allow excessive demands that lead inevitably to continued inflation? I am well aware of the fact that appeals to economic statesmanship often fall on deaf ears--both in private and public life. But lack of impact doesn't detract from the need for such appeals.

As a central banker, I must continue to express concern with inflation. Many argue that such statements of concern only accentuate inflationary expectations. But this type of thinking is the classical example of "if you don't talk about it, it will go away." It won't, our experience tells us this. In 1966, 1967 and 1968 we tried the guns and butter approach, and in addition we weren't willing to pay for it with increased taxes. The result--the reason for my concern.

It is certainly not a foregone conclusion that the severe round of inflation we have experienced since 1965 was inevitable. The great success of the "New Economics" between 1961 and 1964, when virtual price stability coincided with a gradual decline in unemployment, belies that notion. What was lacking since 1965 was not the economic knowledge and tools to prevent inflation, but the political will to use them. If expenditures for the military buildup beginning in 1965 had been financed through a tax increase, instead of through a deficit financed by an unwarranted rate of growth in the money supply, and had we been more prudent in the expansion of our other Government spending programs, we might have enjoyed several additional years of noninflationary prosperity. Instead of harboring deep but unconfirmed doubts regarding the efficacy of "fine-tuning" to guide the economy between the perils of unemployment and the risks of inflation, we might actually have attempted the passage.

Once the existing inflation is under better control, we may have a second chance to navigate these straits. What we must avoid is the temptation to veer too sharply with the wind to try to reach the shore of full employment too soon. If we did this we would surely go aground once more on the shoals of inflation and again be faced with the necessity of patching the ship before setting sail once more. Having successfully passed the shoals--with luck, in the next year or two--we can then proceed on our journey.

If this difficult course of action is followed there is little reason to doubt the early 1970 projections of the President's Council of Economic Advisers of a gross national product of $1.2 trillion by the middle of the decade and $1.5 trillion by 1980, both measured in constant 1969 prices. These figures would be attainable with an average rate of unemployment for the decade of 4 percent, an average annual rate of growth in measured output per manhour of 2-3/4 percent, and an average annual rate of growth in the labor force of 1-3/4 percent. With responsible fiscal and monetary policies, these figures should be compatible with an annual rate of increase in the price level in the latter half--or even the last two-thirds--of the decade of about 2 percent--the average rate of inflation in the United States over the last half century.

On the assumption that population growth to 1980 remains on the low side of projections made by the Bureau of Census in 1967 (which the 1970 Census indicates may be closer to the mark than other, higher estimates), per capita consumption expenditures in constant dollars should increase by about 40 percent by 1980. It is out of this increase that any important rise in federal, state, and local expenditures for pollution control, revamping urban transportation systems, building public housing, welfare reform, and many other wanted programs will have to come.

The long-term outlook for interest rates depends, to a very large extent, on our ability to turn back both inflation and expectations of future inflation. Inflation dulls the incentive to save--and higher savings are the best road to capital formation and further productivity gains. Success as a nation in this effort gives the only hope of somewhat lower interest rates in the face of the tremendous demand for funds in the decade ahead.

If we keep our eye on our objective of greater stability in prices and employment with economic growth--and if we respond promptly and with imagination to changing priorities as we keep our economy on that course --we can reasonably expect the 1970's to surpass in solid achievement the progress of the soaring Sixties. With wise and prudent planning of our public and private activities I am confident that we will reach that goal.