Remarks by Robert P. Mayo
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It is always a pleasure for me to meet with fellow bankers, and I want to thank you for the invitation to participate in your seminar today. You have planned a wide-ranging program covering many of the problems currently facing the banking community. Some of these problems are new, some are of long standing, but I can think of no other problem which the bank executive must continually consider more than his assessment of the current economic climate, the outlook for the future, and the appropriate response of his bank to a changing environment.

The year 1972 was an unusual year. At the same time that our participation in the Vietnam War was declining to a level consistent with virtually peace-time economic conditions, the economy was operating under a system of wage and price controls which were unprecedented except in time of war. As the year began we had just been through a major upheaval in the international monetary system which has yet to be fully resolved. It was a presidential election year which saw changes from traditional voting patterns on a large scale. And this catalogue of unusual features could be extended indefinitely.

Almost any forecaster, had he had advance knowledge of the news events of the year at the beginning of 1972, might well have been pessimistic about the economic outlook for the year. Yet 1972 was an extremely good year for the American economy from almost every point of view. The economy's performance exceeded the earlier expectations of all the widely publicized forecasts, including that made by the Administration. The 9.7 percent growth in gross national product was the highest rate achieved in 20 years. The 3 percent inflation rate was the lowest since the inflationary cycle began in earnest in the late 1960's, and the real growth rate, after allowing for price increases, was 6.5 percent, the highest since 1966.

This strong performance of the overall economy resulted from significant growth in all of the major components of GNP. The strongest growth was in residential construction, almost 27 percent above the 1971 level. Growth in consumer spending, state and government spending, and business investment all contributed strongly to the total growth. The only area showing a decline was the foreign sector; net exports were about $4 billion in deficit. Even this figure, however, was made up by a substantial growth in exports offset by a still faster increase in imports.

The strength in the economy during 1972 shows up equally clearly when one examines the wide-range economic measures other than the gross national product. The strong gains in employment, farm income, manufacturing orders and backlogs, and the industrial production index are just a few examples.

Financial institutions, of course, shared in this growth and supported it. Commercial banks supplied an increased portion of credit needs. Nationally, total loans of Federal Reserve member banks rose almost 20 percent last year. Wisconsin was in the forefront of this gain--with member banks reporting a 33 percent growth in Milwaukee and about 15 percent elsewhere in the state. A more than usual proportion of this credit went to finance housing and purchases of consumer durables. Lending to business was sporadic but strengthened markedly in the final quarter, and for 1972 as a whole, business loans rose more than twice as fast as in the previous year. In addition, the banks continued to purchase state and local securities, supporting record spending by these entities.

Taken as a whole, 1972 was a year which saw the economy take a major forward step on the path leading back to operation at full potential. Furthermore, the 4th quarter of the year was stronger than the year as a whole. The continuing accumulation of manufacturing backlogs, increasing capital appropriations, housing starts, and new construction contracts all suggest that the momentum which has built up in the economy is sufficient, in itself, to continue the growth trend at rates above the long term average well into 1973.

Federal fiscal policy which, despite highly desirable budget cuts, will be stimulative throughout most of the year, combined with the momentum in the economy, has lead most economists to expect that 1973 will be another year of economic growth at a rate well above the long-term trend. I cannot recall a year in which the pronouncements of all of the respected economic forecasters have been so unanimous, not only in their optimism, but also in the narrow range of their specific estimates. The consensus forecast appears to be for a year of real growth about equal to 1972, with a slightly larger increase in price levels than occurred last year. There is also general agreement that the rate of growth will taper off as the year wears on, carrying the faster than normal growth of the economy closer to its full-employment potential. The various forecasters almost all expect continued growth in consumer spending and private investment. They generally forecast a slowdown in residential construction, but with the slack more than compensated by growth in commercial and industrial building. Inventory accumulation is expected to contribute its share to total investment, and state and local government spending is expected to continue its pattern of significant growth.

Credit demands can be expected to reflect these trends. As is often the case in an upswing, the impact of these demands on the banks may lag the greatest period of expenditure acceleration resulting in credit demands reaching their peak in the current year. Business needs for credit, both short-term loans to finance inventories and longer-term funds to finance plant and equipment expansion are likely to accelerate in the months ahead as the cushion of corporate liquidity built up in the last three years is absorbed. This is the type of situation typically associated with strong expansion in bank loans to business. At the same time, the consumer shows no indication of slowing his expenditures. While both Federal and local borrowing needs appear modest by comparison with recent years, there will be a very large volume of public financing and refinancing that the banks will have to help underwrite.

All of this sounds great, for it implies further declines in the unemployment rate and significant gains in per capita real income. And I must admit that if I had to sit down and make a formal forecast on the basis of the data now available, I would be hard pressed to find reasons for not coming up with something closely resembling the consensus forecast. Nevertheless it is important not to let the rosy glow conceal the fact that there are some distinct hazards in our path. The dangers we face are those which grow out of excesses.

We must not forget, in the midst of our contemplation of a prosperous outlook for 1973, that we have just come through a painful experience in our attempts to undo the damage done to price stability by the overheating in the economy which was permitted, in fact encouraged, to occur in the 1966-68 period. As measured by the level of the GNP deflator, the price level was 38 percent higher in the 4th quarter of 1972 than in 4th quarter of 1965, an average annual increase of over 4 percent. During the previous six years the annual rate of increase had averaged about 1 3/4 percent, substantially below the 2.7 percent rate for the 4th quarter of 1972, of which we are all now so proud. Certainly getting down from the 6.6 percent rate that prevailed in late 1969 and early 1970 to the present level has been a major accomplishment, but it has been done at great cost. The many billions of dollars worth of goods and services foregone by the nation during the recent recession represented a cost to all of us, and those who found themselves in the increased ranks of the unemployed certainly paid a very high and personal cost for the restoration of stability.

Furthermore, this reduction in the inflation rate was significantly enhanced by the impact of the controls during Phases I and II of the President's New Economic Program, now almost 18 months old. The sluggishness with which prices reacted to the more conventional means of slowing the economy, by putting downward pressure on demand, suggests that it would have taken a much more severe recession than the one from which we are now recovering to break the inflation cycle, with still higher costs to the economy and deprivation of a still larger share of our labor force.

This cycle of inflation was a new experience in the U. S. economy. We have had rapid bursts of inflation before, but when restraint was subsequently applied, price and wage levels responded almost concurrently with the slowdown in business activity. Two explanations have been suggested as to why the response was so sluggish this time. One explanation is that the structure of the economy has departed too far from the ideal of perfect competition. The development of giant corporations, giant unions, industry-wide bargaining, and long-term labor contracts has built new rigidities into the wage-price structure. This delays, perhaps even prevents, a normal adjustment of wages and prices under the influence of economic slowdown. The second explanation is framed in terms of psychology. The long sustained increase in prices which occurred in the second half of the 1960's was a new experience. The nation came not only to accept the inflation as it occurred but began to expect it to continue. Inflation became the norm for use in business planning and personal decisions alike. It is argued that this built-in acceptance of inflation as a way of life has, in itself, perpetuated the inflation. Thus the trend of rising wages and prices sustained its momentum even though powerful economic forces were brought to bear to combat it--forces which in earlier times had been adequate to blunt inflation much more effectively.

There is substantial validity in both of these explanations. Market rigidity and inflationary expectations have both acted to impede the effectiveness of restraining monetary and fiscal policies. And both effects are now waiting in the wings, ready to act in speeding another inflationary cycle on its way, if we are foolish enough to again overheat the economy and to press too hard against the upper limits of our productive capacity.

During the past year the combination of wage and price controls and the availability of excess capacity in the economy have combined to significantly reduce the inflationary pressures which had built up in the 1960's. But if we are to look forward to stable growth in the economy at high levels of employment in 1974 and beyond, it seems to me to be essential that we make still further progress in reducing the rate of inflation during 1973. This is not going to be an easy task. The margins of unused capacity and manpower have declined significantly from where they stood a year ago. In many areas we are already beginning to hear of shortages of particular skills, and even of difficulties in finding unskilled labor. In a number of industries, such as steel and petroleum, output is already close to the nominal capacity level. The large gains in productivity which normally accompany a period of recovery are probably behind us. Continued rapid growth during 1973, by further reducing these margins, will increase the difficulty of moving toward further price stability. At the same time we have moved from Phase II of wage-price controls to Phase III--with greater emphasis on voluntary restraint.

How, then, can we expect to reach the objective of further reduction in the inflation rate during this year in the face of increasing pressures in the other direction and with guidelines substituted for controls? I think the answer lies in our response to the concept of restraint implicit in the Phase III program and in our response to the President's inaugural theme of personal responsibility.

These concepts of restraint and responsibility are not just applicable to pricing decisions and wage demands, although how well the new guidelines are observed by both labor and management in the next few months will have a direct bearing on the outlook. These concepts are equally applicable to the individual consumer, to the financial community, and to the makers of monetary and fiscal policy.

In large measure, the Federal government, through its fiscal actions, will determine the success or failure in meeting its own inflation reduction goals. It is clear that the government's lack of restraint on spending during the late 1960's when it was unwilling to raise taxes, when the economy was going full speed ahead, provided the spark to generate the inflationary cycle in the first place and the fuel to feed it as it grew in intensity. It will not only be impossible to reduce the rate of inflation, but we will be faced with a new outbreak unless the rate of Federal expenditures is confined to levels consistent with the revenues available to fund them as the economy approaches the full-employment level. If the funds appropriated for fiscal 1973 were to be expended in normal fashion, spending for this year would be far above the full-employment revenue level. Even if the Administration is successful in holding spending down to the $250 billion target level for fiscal 1973 and fiscal 1974 is held to the new budget's projected $268.7 billion, the impact of fiscal policy on inflation will be about neutral, unless revenues exceed current estimates.

It would be a utopian dream to expect that the Congress will accede to the budget exactly as presented to it by the Administration. Congress has both the right and the responsibility to influence the priorities for Federal expenditure. It is not unreasonable to hope, however, that the Congress will recognize the urgent need to legislate a total expenditure program which is consistent with the objective of restraining inflation. The individual members of the Congress have generally indicated their recognition of the need to control total expenditures. But for too many years the congressional machinery has not provided the vehicle to facilitate the necessary overall control. The approach to the appropriation process has been piecemeal, one appropriation bill at a time. Little specific consideration has been given to relative program priorities or to the share of the nation's total output allocated by government action. It is particularly urgent at this stage of the fight against inflation that the Congress take constructive action to improve its performance in the budgetary process. A broad range of suggestions have been made as to how the necessary total budget orientation can be achieved, and a special joint committee was created last fall to make recommendations for congressional reform. It seems to me that most important of all is to initiate some procedure for getting the legislative phase of the budgeting process under control in time to be effective for fiscal 1974, and not to extend consideration of the problem indefinitely until the optimum mechanism is found. If further improvements are found to be needed, they can be implemented later. Control of expenditures for the next fiscal year should not be lost by default.

In moving from the controls of Phase II to the restraint of Phase III, the Administration has transferred an important share of the responsibility for control of inflation to the private sector. While the Cost of Living Council has retained the right to roll back excessive price or wage increases, relaxation of reporting requirements and reduction of the monitoring staff have shifted the center of action from government to individual firms and unions. The first major test of the effectiveness of this new approach on the wage front will come in April with the negotiations between the major tire companies and the rubber workers. If these negotiations result in an agreement in compliance with the guidelines, they will provide an important precedent for other major labor negotiations scheduled during the summer and fall.

The concepts of responsibility and restraint are also applicable to the behavior needed from the financial community, for excessive expansion of credit in the private economy can easily fuel the development of excessive demand and unsustainable, inflationary growth in the economy. Monetary policy, as implemented by the actions of the Federal Reserve System, has for the past several years been conducted with careful consideration of the relationship of the rate of monetary expansion to inflation. As Chairman Burns pointed out in his major presentation to the American Economic Association at year end, more attention has been paid to monetary aggregates during recent years than had previously been true. More recognition has been given to the likelihood that excessive credit expansion may occur in periods of rapidly increasing demand if the primary focus of monetary policy is on interest rates. Nevertheless, the cost of credit and the condition of financial markets cannot be ignored in establishing monetary policy if the health of the economy is to be sustained.

Since early 1970, monetary policy has been conducted so that money supply growth, as well as the growth of the broader measures of credit availability, has been in fairly close line with the needs for growth in the economy. In general the money supply has grown at about the rate of the real growth of the economy--and significantly below the rate of increase in current dollar output. Under these circumstances, monetary policy has made a significant contribution to the decline in the rate of inflation, while still making the funds available which were necessary to sustain the expansion in output and employment. There has been some criticism of the increase in the rate of monetary growth in the last few months, but it is difficult to disentangle what has been real increase and what has been an inevitable result of the changes in Federal Reserve regulations implemented late last year. I am confident that monetary policy will continue to be to support reasonable economic growth without encouraging credit expansion at an inflationary rate. However, given the need to prevent overheating in a very bouyant and optimistic business situation, the climate in which banks will be operating is likely to be somewhat different this year than it was in 1971 and 1972.

An important role, of necessity, will be played by the banks, and you are sure to face greater challenges in performing your economic function as the margin of unused resources narrows. Given the way our economy is structured, and rejecting, as we do, controls over the allocation of resources either directly or through regulation of the composition of the assets of financial institutions, there is really no way that public policy can work to avoid excess demands without having a restrictive impact on the overall growth of the banking system. Responsible monetary policy cannot supply reserves to support deposit growth at a pace that will regenerate inflationary pressures. But this does not mean that the spigot will be shut off. It undoubtedly does mean smaller deposit gains in 1973, at least in percentage terms, than you have experienced in the past two years, but those were very large. The increase in total deposits was about 12 percent in each year nationally.

Last year Milwaukee banks reported increases over 10 percent in both demand and time categories. At other Wisconsin member banks, demand accounts rose 7 percent and time deposits 10 percent. It is not possible to predict in what degree this expansion may be slowed in the effort to match the availability of funds with the economy's ability to increase goods and services. Some banks, especially smaller ones, may feel little if any effect. In any event, there does not appear to be any reason to expect the effects to become excessively burdensome.

Moreover, I would not expect any such slowdown in deposit expansion to cause distortions in the composition of credit or the availability of credit to certain types of borrowers. Even large banks have expanded their mortgage and consumer loans sharply in recent years, and there is no reason to expect that they will withdraw credit from these sectors. But some slowdown in demands for credit by households from the feverish pace of the past year may be expected, and indeed would contribute to a more balanced growth.

The outlook for 1973, then, is one for good economic growth and further reduction of unemployment. But it is also a year in which the decisions in fiscal policy, in wage negotiations, in pricing decisions, and in monetary policy will determine whether it is a year which perpetuates a period of economic growth and price stability, or is the first year in a new cycle of inflationary overexpansion. How well we apply the lessons of the past few years will determine which of the alternatives will be the best description when we close the books next December.