Remarks
of Mr. Robert P. Mayo
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The tone of the announcement sent out for this meeting, which emphasized inflation and financial market strains, may now seem somewhat dated to some of you. It isn't. There is still no question that inflation remains a difficult and serious problem for us and for the rest of the world. There are still potentially serious financial market strains. But those financial market strains have become less severe and public attention has been shifted, perhaps unfortunately, rather dramatically to the current news of economic slowdown.

In spite of the growing sluggishness of the economy, the problem of inflation cannot be ignored. But neither can the costs of rising unemployment and foregone output. Both sets of developments must be considered and weighted in the policy process. All too frequently in the past, economic policy has erred in shifting its focus too rapidly or too completely from one problem to the other. The rapid application of demand stimulating actions to arrest a declining economy, without regard to price pressures, runs a serious risk of overstimulating the economy and producing more rapid price increases later on. But blind inflation-fighting--leading to rapid deterioration in economic activity--results in heavy costs too, not only from the depressed economic conditions but also from the creation of an environment in which public demands for rapid acceleration or stimulation mount. Thus, the appropriate course for economic policy, even though lacking in glamour, is moderation--a course which recognizes that the costs of neither inflation nor excessive unemployment can be eliminated completely as we return over time to more orderly economic growth. We are ill-advised to expect government to solve all of our problems and then blame them when they fail. We want and need government leadership in many areas. But we do not want or need dictatorship.

Nevertheless, once again confronted by both declining activity and rising prices, economic policymakers are being bombarded with demands for "new" solutions and for more vigorous programs and actions. But any review of the debates surrounding the summit conferences and the literature, facts, and experience on economic policy should make it clear that there are no simple, costless, new solutions to our economic problems. All feasible solutions have costs, differing only in the size of the costs and in the distribution of the burden by sector and over time. And the principal solutions or policies that have and can be expected to work are variations on the theme of the appropriate use of monetary and fiscal policies--plus, of course, significant changes in our whole governmental regulatory structure.

In my view, the approach of moderation, using traditional economic policy means, is very much a part of the philosophy of President Ford's proposals. Everyone finds fault with at least some parts of the program. I do, too. But these short-range proposals do afford a way of simultaneously combatting inflation, alleviating the disproportionate burdens on selected sectors and encouraging an expansion of much needed capital investment. Very few of us agree on the exact details, but these can be worked out. Nevertheless, if proposals similar to these were adopted, the costs of combatting inflation would be spread more evenly across the economy, providing some assurance that a resumption of economic growth would proceed in an orderly fashion in another year or so.

Monetary policy too has and, I feel, will continue to follow a course of moderation over the period ahead. However, monetary policy can do its best job only if fiscal policy is soundly based. The most severe strains on the banking system and the financial markets seem to have abated. The earlier fears of excessive monetary restraint have proved unfounded. The necessity and appropriateness of strong monetary restraint during the late spring, summer, and early fall of this year was, I feel, quite clear. In my humble, but admittedly biased opinion, monetary policy has probably been the most effective anti-inflation tool employed in 1974.

Conclusions that restrictive fiscal and monetary policies of 1973-74 have been unsuccessful since prices are still rising rapidly are not correct. Traditional policies still work, though more slowly when inflation is so pervasive and stubborn. We are too impatient in looking for immediate results. But realizing that response lags exist is not tantamount to concluding that we "turn tail" and concentrate exclusively on rising unemployment and declining real output. Monetary policy still has the key role in achieving our inflation-fighting goals, supported by proper fiscal policy, of course. In my view, we must move cautiously yet firmly with our policy actions, giving appropriate consideration to both the inflationary pressures and the extent of weakness in the real economy.

With a "softer" economy, the degree of monetary restraint will appropriately appear to have lessened. Credit demands show signs of leveling. And the severity of uneven sectoral impacts on credit and financial institutions from the stringency are showing some of the initial signs of moderating.

There is no question that our financial markets and the U.S. banking system have been under rather severe strain. They have been operating in a difficult economic environment--with rapid inflation, exaggerated credit demands, significant monetary restraint, historically high interest rates, and a pervasively gloomy stock market. Adding to this, we have seen significant management errors in several banks leading to the two largest bank failures in the nation's history. The net result has been unfounded rumors about individual banks and more questions about the soundness of the nation's banking system than we have heard in many years.

But our banking system is sound. Like the rest of our economy, as an industry, it has tended to expand too rapidly and it needs more capital. But it is sound.

Unfortunately, in grasping for news, the press in reporting rumors or minor difficulties has frequently embellished the stories with recitations about supposed or irrelevant banking difficulties. Or they have repeated in each new story the full recitation of earlier stories of problems individual banks had experienced for the benefit, I suppose, of those readers who might somehow have forgotten last week's episode. In doing so, the press has done a disservice to the American public. Certainly, failures and losses occurred (most of them abroad), but there were no serious repercussions on other banks or business in this country. The failures of U.S. banks did not result in any loss to depositors.

The story that should have been told was the evidence provided by these events as to the strenth of our financial <u>system</u>--the ability of that system to absorb shocks. We have Federal insurance of deposits in place to protect the public--and it has been recently increased to $40,000 per account. We have a Federal Reserve System which is capable and willing to come to assistance as a lender of last resort in the public interest. Make no mistake about it, such assistance is and will continue to be in the public interest. Some have made critical comments that it is unfair that banks are protected from failing while other businesses are not. But what we protect is not the banking firm--the stockholders and owners of the enterprise usually lose--but a sound, efficiently functioning banking system. Without that system, this economy cannot function. It cannot develop and grow.

In times such as these, the strength of that system is tested. It is passing the test.

But other tests are perhaps on the horizon. As various groups press for expansion of economic activity in the sectors they represent, banks will again be in the spotlight. The spector of arbitrary credit allocation by government regulatory authorities, having made its appearance earlier in a period of monetary restraint, is reemerging as a device for bringing about economic expansion. I hope that credit allocation can be avoided. Determination of appropriate allocation outside our free market mechanism is an almost impossible task, even if the decisionmakers possessed infinite wisdom. And with the relative openness of our money and capital markets, credit wouldn't stay allocated beyond the first step without a massive control system.

In the period ahead, there is likely, too, to be continued debate on the impact of the reflows of petro-dollars on free world financial markets. There is no doubt that U. S. capital markets and financial firms will be deeply involved and affected by the attendant financial flows and the market structural changes they portend. But all of the implications cannot be sorted out yet since we do not know the form or structure of the system that will emerge.

Obviously, the impact on our economy and economic stabilization problems is far more complicated than simply evaluating the effects of a jolting increase in the price of one product. And it is unfortunately even more complicated than just tracing money flows through possible financial market channels. The basic effect of the oil price explosion is to bring about a massive redistribution of wealth which will eventually have significant welfare implications and lead to widely varying changes in the prices and quantities of goods and services moving among the countries of the world.

Over the long term we must bring about a reduction of the huge imbalance in international payments between the oil producers and the oil consumers. The volume of oil payments must hopefully be reduced, and there must be an increase in the oil-exporting countries' purchases of goods and services. But both will take time. Oil conservation measures and the development of alternative energy sources cannot occur instantaneously. Nor can we expect a rapid increase in the ability or desire of the oil-exporting countries to increase imports anywhere near the value of their oil receipts.

In this long transitional period, then, efforts will have to be made to find ways to handle the financial flows. The structure that will emerge can rely heavily on existing market mechanisms and international arrangements already in place. But that will not, in my opinion, be enough. Even with increasing reliance on traditional mechanisms, it is difficult to see how these means can effectively operate to channel sufficient funds to weaker oil-importing countries. Within the bounds of prudent risk-taking roles, there is a limit to what our private markets and institutions can do to avoid the serious disruption of weaker economies and the world's trading and investment patterns. A variety of public and international channels will have to be relied upon. New agencies probably will have to be created, perhaps along the lines suggested by Secretaries Kissinger and Simon during the past ten days. In addition, the International Monetary Fund can help materially. But, the oil-exporting countries may find it desirable to take on themselves a larger share of the risk of financing oil deficits and some of the needs of the undeveloped nations by grants or bilateral credit arrangements.

The period ahead will not be easy. But with American faith in the market system, American confidence in meeting new challenges, and a stubborn American determination to fight for appropriate fiscal and monetary policies, I still believe better prospects lie ahead. Let us not forget that we still have the strongest economy in the world--resource-rich, productive, innovative, and financially sound and imaginative. We have a deep resolve to face our economic difficulties squarely. We will dampen inflation. We will be willing to make the sacrifices that must be made. We will resume sound economic growth. I am sure of it.