Remarks by Mr. Robert P. Mayo
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Chicago to the Chamber of
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March 5, 1975

# No Room for Gloom and Doom

President Ford began his "State of the Union" message, almost two months ago now, by saying that he did not have any good news on the nation's economic and energy situation. Since that time there has been additional news which can hardly be considered good--the unemployment rate increase, the continuing low level of housing starts, a further decline in industrial production and the slow rate of increase in personal income. The press and the political rhetoric is full of gloom and doom, wild comparisons of the current situation with the early 1930s, and even calls for a resurrection of the Roosevelt "New Deal".

But let's put the facts in perspective. These are, indeed, sobering times. No one likes unemployment. No one really wins in inflation. But, given the long inflationary infection we have undergone and the amazing series of shocks to the economy and to public confidence over the past 18 months, I believe the U. S. economy is demonstrating remarkable resilience. Furthermore, buried in the gloomy statistics are little bits of evidence that the conditions necessary for the start of recovery are beginning to appear. There is no room for gloom and doom.

In the late summer of 1973, the economy was in the last stages of an abnormal boom. Virtually every vital material and component-producing industry was operating at effective capacity, and yet shortages and ridiculously lengthy delivery schedules were widespread. Price and wage controls, which had produced a brief, albeit illusory, interruption in the inflation spiral, were becoming increasingly unworkable. Domestic shortages and grey or black markets were beginning to develop for many commodities. Most economists were, at that time, well aware that it was essential for the rate of growth to slow down, and that there might even be a recession in reaction to the overheated growth then in progress. But none anticipated how quickly it would come nor the shock that would bring it about. The oil embargo, followed by the action of the OPEC cartel, and the resulting four-fold increase in the price of oil dealt a stunning blow, not just to the U. S. economy, but to the economies of every nation of the world, developed or undeveloped, that was not in the fortunate position of being able to meet its oil needs from domestic sources.

The immediate impact of the embargo was annoyance and inconvenience--long lines at the gasoline pumps, no gasoline on Sundays, fuel oil shortages, and cooler homes and offices. It is only now, as we look back on all that has occurred, that the pervasive influence of the increase in the price of this one basic commodity, petroleum, can be appreciated. This was the perfect example of the "domino" theory of events. Higher fertilizer and fuel costs forced up farm costs and prices. Higher farm prices and transportation, processing and distribution costs further added to the cost of food, raising retail prices. Similar chains of increases ran through steel to autos, appliances and housing, through electric generation to processing to virtually every manufactured product and directly to the consumer. These increases were quickly followed by demands for higher wages to meet the higher costs of living, and a powerfully expanding spiral of cost increases was generated.

Nor was the increased cost of oil the only blow to the economy. Large foreign demand for food from the 1973 crop, and an ever-growing worldwide shortage of food, led not only to removal of virtually all restrictions on planting for the 1974 crop year, but also to widespread encouragement to the nation's farmers to expand production in every possible way. In this case it was not a cartel of foreign powers, but nature itself that did the dirty work. Spring rains which delayed planting, a summer drought which depressed yields, the early frosts which interfered with harvesting resulted not in the all-time record crops which had been hoped for, but in the smallest overall crop since 1970. Higher grain prices kept the year from being a financial disaster for crop growers, but these same higher prices for grains produced a severe squeeze on livestock raisers and feeders. Caught between sharply increased production costs and market resistance to meat prices from consumers beset with rising prices for everything else, the typical cattleman saw 1973's profits disintegrate into 1974's losses.

In addition to these economic events, the public confidence was shaken by the circumstances surrounding the resignation of President Nixon. The conviction of several men who had been among the most powerful in the nation has clearly had an impact on the confidence of the public in the ability of its political leadership to properly conduct the nation's affairs. While much of this lack of confidence found expression in the results of the election last November, there is still an overwhelming distrust of Washington in general which makes it particularly difficult for either the President or the Congress to arrive at and carry out effective programs with the assurance that the public will respond.

While it is now clear in retrospect that the peak of business expansion occurred sometime during the fourth quarter of 1973, this fact was not so evident early in 1974. The nation's total output declined sharply in the first quarter of 1974 from the last quarter of 1973, but this was largely attributed to the oil embargo, and, when the second quarter showed a small increase, many observers thought that the worst was over. However, the downward pressures were building up. Housing starts continued their downward slide. Personal income, while rising throughout the year, lagged behind the rate of inflation, so that real purchasing power declined. Inventories were growing slightly faster than sales, and the impact of higher farm and energy prices was gradually seeping through the economy.

Nevertheless, for the first three quarters of the year the performance of the economy was fairly good. Industrial production was stable. Employment was rising fast enough to keep up with the labor force growth, and, as recently as September, was the highest in our history. The unemployment rate, after a midyear dip, was about the same in September as it had been the previous January. At the time of the economic summit conferences last fall, the whole focus was on stopping inflation, and the recommended solution to the problem was a tax increase to slow things down. Virtually no one anticipated that the downward pressures already in existence would culminate in the sharp deterioration which occurred in November and December, and which continued into the current year. To all of the other downward pressures which had been building, two additional dislocations were added. The introductions of the new 1975 auto models were very disappointing and the coal strike caused secondary production interruptions with serious consequences to output and employment. The sharply higher prices for 1975 cars, combined with the industry's assumption that the consumer now wanted a small car with the luxury features of the biggest cars, met a wall of consumer resistance, and, amid the massive layoffs, the auto companies are still struggling to get rid of enormous inventories built up earlier in the model year. But consumer resistance was not limited to autos alone. Appliances and nondurables were hit as well. Even the growth in spending on services felt the result of what can be accurately described as a consumer slowdown. In the face of uncertainty about employment or, worse, actual job loss, and the lack of a clear cut policy from the federal government, consumers suddenly became massive savers. Shortages of materials and components were converted to surpluses in a remarkably short period of time. The stage was set for a classic inventory liquidation recession. In a sense, what we have been through can almost be viewed as two recessions back to back, first the reaction to the embargo, massive price increase for oil, and the poor crop year, followed, without any real recovery, by an inventory liquidation recession.

I have taken a great deal of your time to review where we have been for the past several quarters, because I think that it is important that we understand the nature of the underlying problems in forming a judgment about the outlook for the economy, and the conditions under which recovery from the present recession must occur if we are not to get back on the super-expansion, inflation, recession roller coaster. For the first time the United States must formulate economic policy and structure its economy around high energy costs instead of the progressively lower energy costs we have had for several decades. From the viewpoint of purely academic economics there are no theoretical reasons why we should not continue to rely as heavily as needed on imported oil. But, from a practical and political viewpoint, the national interest, indeed the national security, demands that we extricate ourselves as rapidly as we can from the position where the action of any group of foreign powers can use our oil requirements as a weapon against us or to blackmail us into policies contrary to our desires. This means we must do three things:

1. Learn how to achieve modest economic growth while holding the rate of increase in energy consumption below historic levels.
2. Expand our internal supply of energy from conventional sources--coal, oil, gas, and nuclear fission--as rapidly as possible, carefully observing environmental restraints not letting overzealous restraints suffocate us.
3. Concentrate our technological resources on the development of new energy sources--geothermal, solar, and nuclear fusion. The latter two, particularly, hold some promise of eventually restoring energy costs to the levels which prevailed before October, 1973.

In addition to the restriction on economic recovery which comes from our energy situation, we must also find a path toward recovery which simultaneously continues to lower the level of inflation gradually toward the level of the early 1960's. Doing this will probably be even more difficult than facing the energy problem.

The general opinion of most forecasters, both in and out of government, is that the economy will return to a path of increased growth some time during the second half of this year. It is expected generally that by that time the inventory liquidation will have run its course, mortgage funds will be more readily available, and some revival will have occurred in the housing market. The federal government will be stimulating demand through a record rate of deficit spending, probably even more than the total deficit for a period from July 1974 through September 1976 of $90 billion which was suggested in the President's budget message.

I stated earlier that, amid the unfavorable economic statistics which have been released with jarring and monotonous regularity in recent months, a few indications of the conditions needed for a turn-around are beginning to appear. Savings flows into savings and loan associations have begun to increase, mortgages are more readily available, and interest rates are declining. The inflation rate, as measured both by the consumer price index and the wholesale price index has slowed. I have the feeling that the actual inflation rate has slowed even more than is suggested by the behavior of these two indexes, because neither of them is designed to take into account the impact on retail prices of special promotions and sales which have been widespread since Christmas, or the increasingly widespread price and term concessions and other departures from official price lists at the wholesale level. While the auto rebate programs have not raised sales to anything like normal levels, they have clearly helped in bringing down the inventory overhang, which must be eliminated before anything approaching normal production can resume in the auto industry. Furthermore, there are several large segments of the economy which have been virtually unaffected, even stimulated, by the current situation. Exploration for petroleum continues to expand and with it the demand for equipment and supplies for drilling. The farm equipment industry, while not expecting quite as good a sales year this year as last, is still struggling to keep up with orders, particularly for the heavier lines of equipment. The machine tool industry is still going full speed while new orders are still being quoted with delivery terms of 12 to 15 months for large and complex equipment. The steel industry is still trying to get back to normal after the partial shut-down for the coal strike. Heavy steel products are on allocation, and mill inventories are badly in need of rebuilding. Freight car manufacturers are at capacity operations, and, given anything like a normal growing season this coming year, crops should be at record levels.

Let me emphasize that these are, as yet, only promising omens for future recovery, not indications that any recovery has yet begun. Furthermore, the recovery, when it comes, will not be a boom but a slow climb back toward more normal conditions. Unemployment seems likely to stay well above levels we would like to see for several quarters after recovery begins. Nevertheless, let me repeat that this is not a rerun of the 1930's even though it is the most severe readjustment the economy has undergone since that very difficult time. That experience led to the creation and gradual expansion of a whole group of stabilizing structures which are now so much a part of our economy we could no longer visualize our world without them--from unemployment insurance to social security, from deposit insurance to the amortized mortgage--a vast underpinning to bolster the economic structure has been built and expanded during the past 45 years.

One of the most essential parts of that structure is the major role of the federal government in the economic well-being of the nation--whether we like it or not is a separable point. It is clear that while the Administration and the Congress disagree as to the details, both are determined to develop and carry out a program to restore economic growth. Where disagreement exists it is on the extent to which the proposed programs can be effective without reinvigorating the inflationary spiral and adding too permanently to the already too heavy burden of government.

These same objectives motivate the policy decisions of the Federal Reserve System in its role in determining monetary policy. Chairman

Burns has made it clear that his objective is to contribute to the maximum extent possible toward recovery with minimum inflation, and that policy has the full support of all of us who play a role in determining monetary policy.

Since mid-summer of 1974, monetary policy has been responding first to the projected and later to the actual weakening in economic activity by encouraging easier credit conditions. Federal Reserve open market operations became more accommodative. These operations were reinforced by other monetary policy tools. The discount rate paid by member banks when they borrow from us was reduced in early December, in early January, and again in early February from its 8 percent peak to 6 3/4 percent. Member bank reserve requirements have also been reduced.

The effect of these actions, along with weaker credit demands by businesses and consumers, has led to sharp declines in short-term interest rates. Long-term rates have declined as well but by less, since lenders are still skeptical about expectations for long-term inflation and that continues to influence the rate at which they are willing to lend. Member banks have repaid their borrowing from the Federal Reserve, which had reached all-time peaks within the past year. And as a result of their overextension of credit in 1971-1974, banks are taking many steps to improve their liquidity.

Some of the so-called monetary aggregates, $M_1$ in particular--demand deposits and currency in the hands of the public--have not shown as much strength as might be desired. The cautious behavior of banks has not resulted in significant credit increases, which in turn means that this narrowly defined money stock has barely grown at all during the last six months. Some of the other measures frequently followed--the other Ms that you have heard about--$M_2$, which included consumer-type time and savings deposits at commercial banks and

$M_3$, a still broader measure that includes deposits at nonbank thrift institutions, have shown somewhat more strength, but are also growing too slowly. All in all, financial conditions have eased--not as much perhaps as some would like, but they have eased.

I would characterize today's monetary policy as one of cautious ease, fully consistent with efforts to restore long-term economic stability, given the inherent lags in the effects of our monetary policy actions. Certainly the most urgent need at the present time is to cushion recessionary forces. But great care must be taken to avoid aggravating the inflationary forces which still threaten us.

This same constraint applies to fiscal as well as monetary policy. I fully support the need for a broadly based cut in individual income taxes and an increase in the investment tax credit for business. I wish we could liberalize depreciation schedules too. But from my experience, I know both the benefits and the dangers of fiscal policy actions--particularly the lagged effects of improperly conceived increases in federal spending. This means that we can not willy-nilly reduce taxes and increase expenditures to moderate the recession and ignore the longer-term implications--serious implications--for returning to economic stability. Creating a quick boom for another bust is inept economic policy for this or any other country.

The Federal Reserve intends, as Chairman Burns has indicated frequently before Congress, to continue to encourage economic recovery by providing for an adequate expansion of money and credit. However, the System has no intention of feeding an explosion in money and credit. The task will not be easy. Federal government deficits could require more financing than even a weak private economy with small credit demands could meet without interest rate increases. But if this should occur, a reckless course of action to hold interest rates down by expanding money and credit could plunge the economy into even deeper trouble in the future.

Let me end where I began. We are in a difficult period, suffering from a serious economic recession in the midst of a serious inflation. Yet appropriate economic policies can lead us gradually along a path of recovery from both afflictions. The frustration and pessimism we see around us has too heavily discounted the basic strength of this economy.

We are the most productive nation in the world. We have a strong currency, despite temporary sinking spells now and then. We have not forgotten that our high standards of living have been achieved only with personal and national sacrifice. As far as I can see, there is no room for gloom and doom.