Economic Recovery
The Problems We Share

Remarks by Mr. Robert P. Mayo,
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to the Midwest-Japan Association
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I am pleased to be back in Japan again and honored to have the opportunity to meet with this distinguished audience. Many things have changed in the last three years since I was here--changes in your society and ours, in your economy and ours. But amidst all the change there are vital elements of stability in our relationship and our friendship:

--our mutual interest in functioning as partners in building a healthy world economy;

--our shared bond of interest in maintaining our democratic values, in upholding our free enterprise system, and in pursuing liberal trade principles.

We all appreciate the opportunity to strengthen these common bonds through our meetings today and tomorrow. I am certain too that my colleagues and I will learn much that will be of value to us.

The U.S. Economic Recovery

Both of our economies have undergone a severe wrenching in the past year and a half. Both economies have experienced the deepest recession since World War II. And both economies have suffered debilitating inflation.

Fortunately, both of us are on our way to rebuilding our economic enterprises. I have noted with pleasure that you have arrested the pace of inflation and brought prices down to a more reasonable degree of stability and that you are now moving toward the restoration of a healthy and vigorous economy.

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As you are all aware, the U.S. economy is also on its way to recovery. The third-quarter figures on real output of goods and services showed over 11 percent growth at an annual rate above the second quarter. This is a sizable upturn, which compares quite favorably to the first few months of recovery in prior recessions. The pickup in activity has been substantiated by our other economic measures as well. Since April, industrial production has increased at about a 12 percent annual rate. Our total civilian employment has increased by 1.6 million since March.

The recovery has been sparked by consumer spending and a significant leveling off in the rate of business inventory liquidation. Residential construction, normally a leader in our recoveries, has not played the same role this time. There has been a pickup in single family housing but the construction of apartments and other multifamily dwellings has shown continued weakness. Capital goods production, a traditional laggard in economic recoveries, has not as yet resumed its upward movement.

In my view, the pace of recovery has been quite satisfactory. Sales of our new 1976 model automobiles appear to have started off at a strong pace. There has been some improvement in truck sales, but mainly in the smaller and medium-sized types. There are promising signs of a pickup in heavy-duty trucks. Retail inventory stocks are well in line and most manufacturers are achieving a desired balance of inventories. Price inflation is currently being dampened by the ready availability of virtually all goods and services.

The momentum of U.S. recovery is building. While I would not expect fourth-quarter gains to match those of the third quarter, which reflected the direct effects of the fiscal stimulus on consumer spending, I expect

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expansion to continue. The major continuing stimulus for recovery appears to be consumer spending. Capital goods industries are likely to lag, with no significant upturn in a broad range of products--including equipment for materials handling, metal-working and most types of construction--until well into 1976. This means that in a regional sense, Chicago and the Midwest are lagging the national recovery.

Of course, I am not so naive as to ignore the fact that there are still many problems on the horizon. The U.S. housing market remains in a difficult position. Housing starts are projected by most U.S. forecasters to rise to only about 1.5 million in 1976 from about 1.1 million this year. But even this modest gain is predicated on the availability of mortgage funds--which could be in doubt if there are reduced flows to our mortgage lending institutions. There are also great uncertainties associated with New York City's financial problems and the uncertain effects of energy and food price pressures. One cannot discount either the fact that projections of continued historically high rates of unemployment will develop pressures for economic action. The development of appropriate policies and the harmonization of our goals of policy--"full" employment, stable prices, and international balance-of-payments equilibrium--will be a formidable challenge.

The Policy Challenges

The American economy, like most of the industrialized economies of the world, has a built-in inflationary bias. The legitimate concern with the waste of resources through unemployment, a failure to recognize the sizable costs of inflation, a strong faith that stimulative economic actions have significantly larger impacts on unemployment than on prices, and

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public expectations that outrun our capacity to achieve them--at least in the time frame desired--have all played a role in creating the bias.

Our economic policy actions have consequently tended to focus excessively on the correction of short-run unemployment problems without sufficient thought to the consequences for prices. And we have in public policy failed to consider fully the priorities which our scarce resources should meet.

Fortunately, I feel that we have an improved capability for planning priorities at the national level. With the passage last year of the Congressional Budget and Impoundment Control Act, our Congress has provided new tools for its own planning, budget setting, and control mechanism. The procedures are being followed this year on a trial run basis and significant progress has been made. Hopefully, the mechanism will be even more effective in fiscal 1977. It must be!

A major cause of inflation in the United States has been the apparent inability of the federal government to control deficit spending over a span of years. I don't think that any economist now would disagree. But for many years, the public, organized labor, the business community, and even many economists failed to recognize that the use of deficits to overstimulate the economy would eventually begin to destroy jobs, not create them. We have certainly learned our lesson with a vengeance.

The challenge for monetary policy is no less difficult. The very favorable third-quarter results had seemed, at the time I left the United States, to have defused some of the concern that monetary policy was too restrictive to insure a continued recovery. But there still is strong support for a more stimulative monetary policy to bring about a more rapid reduction in unemployment.

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In my view, we have limited ability in the U.S. economy today to trade-off more inflation for less unemployment. A highly stimulative monetary policy strategy can only work if the public has what the economists call a money illusion--that is, they confuse changes in nominal income with changes in real income. If the public is confused or alternatively doesn't expect the rate of price increases to accelerate, then you can have an initial impact on unemployment efforts designed to increase money income. The so-called "Phillips curve" seemed to work in the early 1960s when the variations in the inflation rate were low and the public was slow to perceive the changes in inflation rates. But the American public has become attuned to inflation so that the period of time during which the trade-off will work has become shorter and shorter.

A more moderate monetary policy, one which results in a moderate expansion of the monetary and credit aggregates, seems, therefore, to be more appropriate. Such a policy stance has been publicly announced by the Federal Reserve System and calls for policy actions characterized by a 5 to 7 1/2 percent rate of growth in currency and demand deposits (M_1) from the second quarter of 1975 to the second quarter of 1976.

As you are aware, some concern has been raised about the potential conflict in hewing to this moderate path of money expansion in the face of large Treasury financing needs. It is feared that without a more expansive monetary policy, interest rates, already high, would be forced to even higher levels that would significantly interfere with the economic recovery.

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I do not and cannot take a sanguine view of the Treasury deficit. The current Treasury estimate of about $45 billion of new cash in the second half of 1975 must be viewed with concern even though three-fourths of it has now been financed. A continuation of deficits on the current scale cannot be countenanced by anyone truly concerned with the viability of the private sector of this economy.

For my part, I see no basis for the Federal Reserve to accommodate all borrowing demands--both federal and private--by trying to keep interest rates artificially low. To do so would mean giving up efforts to reach ultimately full employment with stable prices--even when we define both of these terms rather flexibily. But not accommodating all of the growing nonfederal needs in the face of continuing budget deficits of this magnitude means federal government control over a larger and larger portion of our total spending. This disturbs me greatly, yet I am convinved that monetary policy cannot and should not be required to make the decision on the allocation of spending between the private and public sectors. Fortunately, as I mentioned earlier, we have established procedures to improve the federal government's approach to planning national priorities. Hopefully, this will serve to lift this unwanted and inappropriate burden from the shoulders of monetary policy.

But that will take time. For the near term, the financial outlook depends critically on whether or not the federal deficit can be held at or near the Administration's budget target. And, of course, the record on the growth of private credit demands is still to be written. I must concede that a strong recovery, with its attendant private credit demands,

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cannot help but put some pressure on interest rates. My hope is that renewed vigor in the economy and tight budgetary control will allow the markets to handle the emerging credit demands in a reasonable manner during the period ahead. Of one thing I am certain, however. The interest rate levels which will emerge will be far lower if we continue to hew to a longer-term path of moderate monetary expansion than if we gave in to the short-run monetary over-stimulators.

Capital Formation

Obviously, from what I have said, I consider it particularly important at this juncture to view our policy choices in long-term perspective. Concentration on short-term policy would, in my view, be particularly detrimental to long-term capital formation in the United States since inflation control is an essential element in insuring capital adequacy.

At the present time, there is, of course, no shortage of capital. Concern with the adequacy of stock of capital is a medium and longer-term phenomenon. In that perspective, we must consider the emerging new demands for capital.

Capital needs are clearly rising in our economy for mass transit, energy investment, environmental investment, and health and safety investment. Unfortunately, investment in some of these areas will not add much to output--environmental and health and safety investment, in particular. There may be decreasing investment demand in some sectors such as housing, in some forms of nonresidential construction such as schools, and in inventories, but on balance, most studies indicate that total nonresidential investment will grow from 10 1/2 percent to 11 1/2 percent of gross national product.

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Alone, then, the demand side may not suggest a tremendous pressure for capital expansion. The problem is probably on the supply side.

Consumer savings have shown a remarkable insensitivity to inflation. As a result, the savings to GNP ratio has remained near the top of its 20-year range for the past three years, but there is no reason to expect it to rise further.

Business saving has been severely affected by inflation. Inventory profits generate no cash flow and are not available for investment or dividends. But they do generate a tax liability. Beyond the direct inflation impacts, there is still no assurance that an adjustment to continued inflation would restore profits to their historical proportion of GNP.

The critical area for savings is the government, which has on occasion been a net supplier of savings. But during the last few years, both the federal and state and local governments have been net borrowers.

Much has been made of the fact that inflation pushes taxpayers into higher tax brackets, raising the effective tax burden and that this effect has not been fully counteracted by tax cuts. I have some reservations about our being able to count on this. The effects of inflation on tax brackets have been compensated for by tax cuts. A slowdown in government expenditures, while highly desirable, will not necessarily materialize. Moreover, the trend of state and local governments' expenditures suggests a continuation of deficits there.

These concerns, plus others that might be mentioned, such as the difficulty of tapping equity markets, lead me to believe that a capital shortage could appear in the United States. The problem would seem to focus on the

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supply of savings rather than demand. While not the complete solution, greater price stability does appear to be a necessary condition for generating the savings required.

The International Focus

So far, I have concentrated on developments in our domestic economy. Let me now broaden the view and look at these developments in an international context. In a sense, it is not a shift of focus. We in the United States--whether as businessmen or as government officials--have long ago shed our "insular" conception of ourselves that has been attributed to us by some of our friends abroad. We fully recognize the interdependence that exists between all the economies in the free world, and we recognize the challenges --and responsibilities--that stem from that interdependence for the United States as the largest member of that family of nations. We do conceive of our actions, of our national developments, and of our national economic policies in a global context. Our policy goals of well-balanced economic growth in a noninflationary environment are as relevant for us as they are for you here in Japan, and as they are for our friends in Europe and elsewhere in the world.

Over the past several years we have both experienced the most pernicious inflation all of our counties have seen in recent memory; the trauma of the energy crisis--much harder on you than on us, and the sharp decline in our economic activities. We must now embark together on a path that will leave these problems behind us.

In the international monetary area we must work together toward an evolution of a system that will serve to accommodate the flows of goods, services, and productive capital among nations. We have made great progress

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toward this goal in the three short years since I had the privilege of addressing this group the last time I was here in Tokyo. Our governments, working closely together and with others who share our goals, have implemented changes in the international payments mechanism that proved to be well-suited to withstand the shocks that the world economy has been subject to in the recent past without a breakdown in the vital flows of international commerce. We have jointly put in place a world monetary system that is far more responsive to the underlying fundamental economic realities than was the system around which our discussion at the last meeting in which I participated here revolved. Clearly, we still have a long road ahead of us. The system of floating exchange rates now in place must be refined and modified in a forum of international negotiations to eliminate some of its undesirable side effects. And there are many other problems that we face together in this area. But the progress that we have made together in those three short years makes me confident that these problems will be solved.

And I am equally confident that with the system now in place, strengthened by refinements that are being worked on, and bolstered by an increasingly more healthy and buoyant world economy, the balance-of-payments "problems" that beset us all in the aftermath of the energy crisis, will be considerably reduced. Both of our countries have already made a tremendous recovery from the trade deficits that we experienced in 1974, largely as a result of the increase in the price of oil we import. In the case of the United States our trade balance swung from a deficit of some $2.3 billion in the last half of 1974 to a surplus of $5.4 billion in the first half of 1975. In the case of your country the swing was equally spectacular. Indeed, the

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rate of our trade balance recovery has not only significantly contributed to the overall economic recovery that we are now beginning to experience but also has placed us both in an almost embarrassing situation with respect to other countries that, together with us, must jointly bear the "oil deficit."

It must be recognized that the historically high U.S. trade surplus so far this year has been the product of unusual and rather transitory developments. One of these was, of course, the depressed state of the U.S. economy that has caused a sharp decline in our imports--a situation very similar to yours. With the pickup of activities now well under way, our imports will also increase. We are detecting that influence in our most recent trade figures. The other element in our strong trade picture has been the performance of our exports that, in the aggregate, held up relatively well in the face of the worldwide slack in demand. Here, clearly, the strength of our agricultural exports in a world faced with shortages and rising prices was an important element. Also, the depreciation of the "floating dollar" in late 1974 and early 1975--a depreciation that many observers viewed as excessive--no doubt played a significant role in improving the competitiveness of our goods in the world markets and thus contributed to the relative strength of our exports in other categories, including industrial products. Both of these major influences are now moderating. The world supplies and prices of agricultural products are getting into a better balance in the world markets, and the value of the dollar has risen substantially in recent months. We are thus anticipating a considerable erosion of our past surpluses--and a better balance in our trade and current account.

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With a soundly based, noninflationary economic growth in the U.S. economy, we look toward discharging our responsibilities that we keenly feel in this interdependent world, responsibilities for contributing to a better tomorrow for Japanese, for Americans, and for peoples everywhere.

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