Remarks of Robert P. Mayo
President, Federal Reserve Bank of Chicago
before
Des Moines, Iowa Rotary Club
June 17, 1976

I am very pleased to meet today with the Des Moines Rotary Club. It gives me an opportunity to applaud the contribution which you and the more than 16,000 other Rotary Clubs have made all over the free world. I have always been impressed as so many, many others have, that your guiding principle of "Service Above Self" has, and continues to be, a very real commitment. Praise for compassionate service to society is all too frequently taken as mawkish sentimentality. But I am not concerned that some may interpret my remarks in that way. I feel strongly that it is the individual and the voluntary enthusiasm of private groups that must be the center of efforts to maintain and extend the benefits derived from our uniquely free and productive society.

My views on the importance of the private sector are in no way inconsistent with the fact that I come from what some call a quasi-governmental organization. In fact, there is at least one major similarity between your organization and mine. We are both keenly interested in serving the public interest.

Before plunging into the topic Tom Cooper suggested to me some months ago--recent economic developments--let me say a few words about the Federal Reserve System and its role in our economic well-being. This seems to be a particularly good time to do so since the Fed has been getting a great deal of press. Not only has the Congressional spotlight

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BEEN TURNED ON THE STRUCTURE OF THE FED, BUT THERE HAVE BEEN NUMEROUS QUESTIONS ABOUT OUR BANK SUPERVISORY AND REGULATORY FUNCTIONS, OUR PAYMENTS MECHANISM ACTIVITIES, AND THE APPROPRIATENESS OF OUR MONETARY POLICY ACTIONS.

I WON'T ATTEMPT TO COVER ALL OF THE ISSUES THAT HAVE BEEN RAISED. BUT I DO WANT TO EMPHASIZE TWO FUNDAMENTAL ASPECTS OF THE FED THAT ARE FREQUENTLY OVERLOOKED BECAUSE THEY SEEM SO OBVIOUS. YET, THEY ARE AT THE VERY ROOTS OF THIS SUCCESSFULLY FUNCTIONING CENTRAL BANK.

THE FIRST I'VE ALREADY MENTIONED--THE FED EXISTS TO SERVE A PUBLIC INTEREST. THIS MAY SEEM OBVIOUS SINCE THE SYSTEM WAS CREATED BY THE CONGRESS AND CAN BE MODIFIED AT ANY TIME THAT THE CONGRESS WISHES. BUT, INTERESTINGLY, THAT HAS NOT BEEN THE WAY IN WHICH THE FED HAS BEEN VIEWED BY MANY IN OUR SOCIETY. BECAUSE OF ITS EXTENSIVE INTERACTION WITH ONE INDUSTRY--COMMERCIAL BANKING--THERE HAS BEEN A WIDESPREAD MISCONCEPTION BY THE PUBLIC, BUSINESSMEN, SOME MEMBERS OF CONGRESS AND EVEN SOME BANKERS THAT THE FED SERVES A PARTICULAR INDUSTRY INTEREST--AND IS THE HANDMAIDEN, OR EVEN A LOBBYING ORGANIZATION, OF THE BANKS--RATHER THAN SERVING THE PUBLIC INTEREST. WE HAVE BEEN VIEWED BY SOME AS A SPECIAL KIND OF CORRESPONDENT BANK, A TRADE ASSOCIATION, AND EVEN A FINANCIAL CABAL FOR THE PERSONAL AGGRANDIZEMENT OF A SECRET AND PERHAPS SINISTER FEW.

IT IS HARD TO SEE HOW THESE VIEWS COULD HAVE BEEN GENERATED. THERE IS NO EVIDENCE TO SUPPORT THEM. IN FACT, THE CONGRESS ITSELF HAS CONTINUED OVER THE YEARS TO ASSIGN NEW RESPONSIBILITIES--NEW PUBLIC RESPONSIBILITIES--TO THE FED. AND SYSTEM OPERATIONS THEMSELVES OVER THE YEARS ATTEST TO ITS PUBLIC CHARACTER.

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As our society has become more concerned with the responsiveness of institutions to public needs and values, the failure to remember that the objective is public service has led to a great deal of confusion as to what the Fed is and how it should be evaluated. Much of the criticism, be it in the payments mechanism area or in bank supervision sphere, arises because individuals are attempting to evaluate the System as though it were serving a private interest.

The second fundamental aspect of the Fed is its uniquely American form which insures dispersion of power and regional representation. The Congress, in its concern with the concentration of financial power and with narrow or transitory policital pressures not necessarily reflective of the nation's economic priorities, set up a regional Federal Reserve organization with its roots in the various areas of the country and a Board of Governors in Washington insulated from narrow political pressures by appointment for long terms--14 years.

This structure has served the country well. By being here in the Midwest, we obviously have a better opportunity to see the needs and to see the effects of our actions. One example of this is our check clearing office here in Des Moines. The financial needs of the Midwest are being more efficiently served and the public has benefited.

I obviously am a very strong supporter of a regional system. Everyone is touched by the Fed's activity. The Fed fosters and maintains an efficient and viable payments mechanism. Everyone uses checks, everyone needs currency and coin. The Fed provides for the effective supervision and regulation of banks. Everyone uses a bank. The Fed provides fiscal

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AGENCY FUNCTIONS FOR THE U.S. EVERYONE HAS FINANCIAL TRANSACTIONS WITH THE GOVERNMENT, WHETHER THEY'RE BUYING BONDS OR PAYING TAXES.

THE PERVASIVENESS OF FEDERAL RESERVE INFLUENCE REQUIRES REGIONAL REPRESENTATION IF THE PUBLIC INTEREST IS TO BE EFFECTIVELY SERVED.

A RECOGNITION OF THE PUBLIC INTEREST ROLE OF THE FED AND THE IMPORTANCE OF ITS STRUCTURE IS NOT A FULL RESPONSE TO THE ISSUES CONCERNING THE FED. BUT I THINK IT DOES HELP TO PUT THE ISSUES IN PERSPECTIVE. IT IS A PERSPECTIVE THAT WILL KEEP US FROM DEVELOPING COUNTER-PRODUCTIVE PROPOSALS FOR CHANGE--PROPOSALS THAT CAN ERODE THE FUNDAMENTAL STRENGTH OF THE FEDERAL RESERVE SYSTEM.

RETAINING THE STRENGTH OF THE FEDERAL RESERVE SYSTEM IS PARTICULARLY IMPORTANT TO THE SUCCESS OF THIS NATION'S EFFORTS TO MOVE THIS ECONOMY BACK TO SUSTAINABLE PERFORMANCE AT RELATIVELY STABLE PRICES AND HIGH LEVELS OF EMPLOYMENT. LET ME TURN TO THAT ISSUE NOW. WHERE ARE WE ON THIS PATH? WHERE ARE WE LIKELY TO BE GOING? WHAT HAS THE FED'S ROLE BEEN? WHAT SHOULD WE BE DOING IN THE MONTHS AHEAD?

A HEALTHY ECONOMIC RECOVERY IS WELL UNDERWAY. WE ARE LEADING THE FREE WORLD IN THIS REGARD. WE HAVE NOW HAD SOME FOURTEEN MONTHS OF EXPANSION. MOST OF OUR INDUSTRIES ARE CONTINUING TO POST HIGHER RATES OF ACTIVITY.

CONCERN THAT THE PACE OF RECOVERY IS TOO SLOW IS NOW LARGELY BEHIND US. UNTIL THE FIRST QUARTER OF 1976, ONE COULD HAVE ARGUED THAT OUR ECONOMIC REBOUND WAS MODERATE. THE PERCENT INCREASE IN REAL GNP--THE OUTPUT OF GOODS AND SERVICES IN CONSTANT PRICES--DURING THE FIRST THREE QUARTERS OF RECOVERY WAS SOMEWHAT LESS RAPID THAN IN THE RECOVERIES FOLLOWING THE DEEP RECESSIONS OF THE FORTIES AND FIFTIES--ALTHOUGH IT COMPARED FAVORABLY TO THE RECOVERIES OF THE SIXTIES AND EARLY SEVENTIES. BUT THE

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FIRST QUARTER EVIDENCE AND THE ECONOMIC READINGS SINCE THEN HAVE SUGGESTED A VIGOROUS EXPANSION.

YOU HAVE ALL HEARD THAT THIS HAS BEEN A CONSUMER-LED RECOVERY. THE CONSUMER DID TAKE THE LEAD. WITH INCREASED CONSUMER LIQUIDITY, HIGHER INCOMES, THE ABILITY TO TAKE ON MORE DEBT AND INCREASED CONFIDENCE, THE CONSUMER WAS WELL PLACED TO MAKE A MAJOR EARLY CONTRIBUTION TO RECOVERY.

AS RECENT EVIDENCE INDICATES, INVENTORY GROWTH IS NOW BEGINNING TO BUTTRESS CONSUMER SPENDING. THE ECONOMIC DOWNTURN HAD BEEN ACCOMPANIED BY A SIGNIFICANT RUNDOWN IN INVENTORIES THAT HAD BEEN ACCUMULATED UNINTENTIONALLY AS THE DECLINE IN SALES PROCEEDED IN 1974. BY THE END OF LAST YEAR MANY OF THE FIRMS IN THE NON-DURABLE GOODS AREAS HAD REDUCED THEIR INVENTORIES TO ACCEPTABLE LEVELS, SO WHEN SALES EXPANDED THEY MOVED TOWARD RENEWED ACCUMULATION. IN THE DURABLES GOODS AREAS THE PROCESS OF LIQUIDATION TOOK SOMEWHAT LONGER, AND FOR MANY, INVENTORY BUILDING IS ONLY IN THE EARLY STAGES.

THIS TIME, THE UPTURN WAS NOT SPARKED BY AN UPTURN IN HOUSING. THIS FORCE FOR RECOVERY HAS BEEN DELAYED. THE IMPACT ON HOUSING FROM THE DOWNTURN WAS SEVERE. EXTENSIVE SPECULATIVE BUILDING, ESPECIALLY IN MULTI-FAMILY UNITS, IN THE EARLY 1970'S TURNED INTO OVERBUILDING. THE ADVERSE IMPACT ON THE BANKS AND OTHER LENDERS, AS WELL AS BUILDERS, WAS CHASTENING.

NOW, HOWEVER, THE PERFORMANCE IN HOUSING--MOSTLY IN THE SINGLE FAMILY AREA--HAS IMPROVED. HOUSING STARTS HAVE CLIMBED SUBSTANTIALLY FROM THEIR VERY LOW LEVELS LATE LAST YEAR. THE ADVERSE IMPACT OF OVERBUILDING ON BOTH LENDERS AND BUILDERS IS GRADUALLY BEING OVERCOME. BUT,

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THE ENTHUSIASM FOR MULTI-FAMILY BUILDING REMAINS DAMPENED.

SPENDING FOR BUSINESS EQUIPMENT APPEARS TO BE PICKING UP GRADUALLY. THIS HAS BEEN, AS I THINK YOU ALL KNOW, AN AREA OF CONCERN. THE SLOW RECOVERY OF BUSINESS INVESTMENT HAS BEEN SOMEWHAT PARADOXICAL SINCE ALL OF THE MAJOR DETERMINENTS OF CAPITAL SPENDING HAVE BEEN FAVORABLE--THE ACCELERATION OF OUTPUT, VASTLY IMPROVED PROFITS, GOOD CASH FLOW, AND LOWER INTEREST RATES. AN EXCESS OF UNUSED CAPACITY HAS BEEN ONE OF THE CONSTRAINTS ON CAPITAL SPENDING, BUT CAUTIOUSNESS IS ALSO STILL PLAYING A PROMINENT ROLE. BUT IN ANY EVENT, WE DO SEE SOME FAVORABLE SIGNS AND CERTAINLY NO DISTRESSING OMENS IN THIS AREA.

THE NET RESULT OF THESE DEVELOPMENTS, OF COURSE, IS THAT WE HAVE MOVED TO NEW HIGH LEVELS OF EMPLOYMENT. AND ALTHOUGH THE UNEMPLOYMENT RATE REMAINS HIGH BY HISTORICALLY STANDARDS, WE HAVE CONTINUED TO MAKE PROGRESS IN THE RIGHT DIRECTION. AND OUR LONGER RUN PROJECTIONS SHOW THE UNEMPLOYMENT RATE BEING REDUCED FURTHER.

NOR, OF COURSE, SHOULD WE IGNORE THE PROGRESS THAT HAS BEEN MADE IN REDUCING INFLATION. THE RATE OF INCREASE IN PRICES IS STILL TOO HIGH BUT NO ONE COULD ARGUE RESPONSIBLY THAT A SIGNIFICANTLY FASTER RATE OF IMPROVEMENT COULD BE ACHIEVED. BY NOW, EVERYONE SHOULD BE WELL AWARE THAT WRINGING OUT INFLATION IS A LONG DRAWN-OUT PROCESS. HOPEFULLY, WE HAVE ALSO LEARNED THE IMPLICATION OF THAT FACT. ECONOMIC POLICY CANNOT BE DESIGNED TO ACHIEVE RAPID REDUCTIONS IN UNEMPLOYMENT WITHOUT REGARD TO THE INFLATIONARY FORCES BEING PUT IN PLACE. THOSE INFLATIONARY FORCES CANNOT BE INSTANTLY REVERSED. INDEED, BY THE TIME THEY ARE BEING REGISTERED IT IS ALREADY TOO LATE. YOU CANNOT WAIT UNTIL YOU SEE THE WHITES OF INFLATION'S EYES TO ACT. THE JUGGERNAUT CAN'T STOP.

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What about the prospects for a continuation of the advance? A reasonable scenario for a more extended period of economic expansion into 1977 isn't hard to put together. As the upturn continues, additional inventory building appears to be in the cards. Housing, at least in the single family area, will be a likely plus. Inflows of funds into housing financing institutions have grown tremendously. With the low levels of housing activity since 1972, starts are considerably below potential demand. Capital goods investment--while still sluggish--should be building as the year progresses, slowly at first and then more rapidly on into next year.

Recent retail sales figures showing some slowing in consumer expenditures have caused concern in some quarters that the early recovery leader may be falling back. At this juncture, I see no reason for concern. Economic expansions are usually bumpy. In fact, I am struck by how inordinately smooth the advance until now has been.

A few voices are still raising the issue of sluggish performance--particularly in reducing unemployment and have suggested a vigorous expansionary policy on the part of the Federal Government. But the pressures for such policies have not been great, and I think it is in large part because our performance has been excellent.

Inflation is still the main threat to sound economic growth over the next few years. Inflation has been the downfall of all the recoveries and the expansions since the mid 1960's. Certainly price easing has occurred. But much of it has centered on food and fuel. For the moment, at least, fuel price increases seem less likely--except for slightly higher gasoline prices--but food prices remain a question mark, depending

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SIGNIFICANTLY ON THE WEATHER BOTH HERE AND IN THE SOVIET UNION.

PRICES OF WHOLESALE INDUSTRIAL COMMODITIES CONTINUE TO BE UNDER PRESSURE. MANUFACTURERS COULD FOLLOW AGGRESSIVE PRICING POLICIES TO COVER INCREASED COSTS AND MAINTAIN OR WIDEN PROFIT MARGINS. LABOR COST PRESSURES HAVEN'T DISAPPEARED EITHER. WITH SIGNIFICANT WAGE NEGOTIATIONS IN THE WORKS NOW OR COMING UP SOON, THIS HAS TO BE AN AREA OF CONCERN.

MUCH DEPENDS, THEN, ON GOVERNMENT ECONOMIC POLICY. A MORE STIMULATIVE POLICY NOW, STRETCHING TO ATTAIN AN 8 OR 10 PERCENT REAL GROWTH RATE IN ORDER TO BEING THE UNEMPLOYMENT RATE DOWN MORE RAPIDLY COULD, I FEEL, BE A VERY COSTLY MISTAKE. THE IMPACT OF MORE EXPANSIVE EFFORTS NOW WILL BE FELT IN THE ECONOMY NEXT YEAR WHEN THE EXPANSION IS EVEN FURTHER ALONG. BUSINESSES AND CONSUMERS WERE SHELL-SHOCKED IN 1974 AND 1975 BY THE RAPID PRICE INCREASES. THEY DON'T NEED OR DESIRE WHAT SUCH A GOVERNMENT PRESCRIPTION CALLS FOR--ANOTHER DOSE OF DOUBLE DIGIT INFLATION. YOU CAN'T CURE THE ANEMIA OF UNEMPLOYMENT BY GIVING THE PATIENT THE HIGH BLOOD PRESSURE OF INFLATION. EVERY WORKING MAN IN AMERICA HAS A VESTED, SELFISH INTEREST IN BRINGING INFLATION DOWN EVEN FURTHER.

I THINK, HOWEVER, THAT THE ODDS FAVORING SOME MODERATION IN GOVERNMENT SPENDING ARE FAIRLY GOOD--EVEN AFTER THE NOVEMBER ELECTIONS. MEMBERS OF CONGRESS ARE VERY SENSITIVE TO THE SIZE OF THE FEDERAL DEFICIT. THEIR NEW BUDGETING PROCEDURES SEEM TO BE HELPFUL. NEXT YEAR'S DEFICIT WILL STILL BE TOO LARGE BY PRUDENT STANDARDS BUT WILL REPRESENT A SIZABLE REDUCTION IN STIMULUS.

AS FAR AS MONETARY POLICY IS CONCERNED, IT HAS AND WILL CONTINUE TO BE DESIGNED TO INSURE ADEQUATE PERFORMANCE WITHOUT EXACERBATING INFLATION. THE THRUST OF THIS POLICY HAS BEEN LAID OUT PUBLICLY. THE FED WILL BE

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ACTING TO PROVIDE THE BANK RESERVES NECESSARY TO INSURE GROWTH IN CREDIT AND MONEY CONSISTENT WITH THAT GOAL.

YOU WILL NOTE THAT I HAVEN'T STATED THIS POLICY IN TERMS OF INTEREST RATES. UNFORTUNATELY THE IMPACTS OF MONETARY POLICY ARE TOO FREQUENTLY CHARACTERIZED SOLELY IN TERMS OF THE FED SETTING INTEREST RATES TOO HIGH OR TOO LOW. I CANNOT STRESS OFTEN ENOUGH THAT THE FED DOES NOT SET INTEREST RATES. IT CAN AND DOES HAVE SOME INFLUENCE IN THE SHORT RUN ON SOME INTEREST RATES BUT IT CANNOT SET OR CONTROL THEM. INTEREST RATES ARE DETERMINED BY THE SUPPLY AND DEMAND FOR FUNDS IN THE MARKET.

THE RECORD IS VERY CLEAR ON THIS POINT. ANY ATTEMPT TO KEEP INTEREST RATES LOW AS CREDIT DEMANDS GROW IS A LOSING BATTLE. AS BANK RESERVES ARE PUMPED IN TO KEEP RATES DOWN, THE MONEY SUPPLY GROWS MORE AND MORE RAPIDLY. PRICES BEGIN TO RISE, EXPECTATIONS OF EVEN MORE RAPIDLY RISING PRICES MOUNT, AND INTEREST RATES GET ANOTHER PUSH UPWARD. IT BECOMES A VICIOUS CIRCLE OF RISING PRICES AND INTEREST RATES.

WHY STRESS THIS? SIMPLY TO INDICATE THAT EFFORTS TO MAINTAIN AN APPROPRIATE NONINFLATIONARY EXPANSION OFTEN MEANS SOMEWHAT HIGHER INTEREST RATES AT THE OUTSET. IN AN EXPANDING ECONOMY, PRIVATE BORROWERS NEED MORE CREDIT. AS DEMANDS RISE, SOME INTEREST RATES, ESPECIALLY IN THE SHORTER TERM AREA, WILL ALSO RISE. UNFORTUNATELY, A MISUNDERSTANDING OF THIS PHENOMENON HAS LED TO CONCERN AT THE FIRST BLUSH OF INTEREST RATE INCREASES. YET SUCH EARLY ACTION WILL RESULT IN LESS RAPID INTEREST RATE ADVANCES LATER AND FEWER PROBLEMS IN MAINTAINING PRICE STABILITY.

THERE HAS, I FEEL, BEEN AN OVERREACTION IN THE MARKETS RECENTLY. BOTH SHORT AND LONG-TERM RATE MOVEMENTS HAVE BEEN EXAGGERATED BY THE MARKETS. IN THE SHORT-TERM MARKET IT HAS BEEN AN OVERREACTION TO

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ANTICIPATED FED ACTIONS. IN THE LONG-TERM AREA, THERE APPEARS TO BE A MISINTERPRETATION OF THE IMPACT OF FED ACTIONS. ACTIONS TAKEN TO KEEP THE MONETARY AND CREDIT AGGREGATES UNDER CONTROL THAT RESULT IN SOME SHORT-TERM RATE INCREASES ALSO MEAN THAT THE LIKELIHOOD OF HOLDING DOWN FUTURE INFLATION IS ENHANCED. THAT SHOULD SERVE TO MODERATE INCREASES IN LONG-TERM INTEREST RATES SINCE INFLATION EXPECTATIONS ARE THE KEY FACTOR IN THE OUTLOOK FOR LONG-TERM RATES. THE COURSE OF OUR INFLATION FIGHT IS, THEREFORE, CRITICAL TO THE OUTLOOK FOR INTEREST RATES.

ALL IN ALL, THEN, IT SEEMS TO ME THAT CONDITIONS DEVELOPING IN THE ECONOMY AND EMERGING ECONOMIC POLICY GIVE GOOD PROMISE OF THERE BEING A SOLID PERIOD OF ECONOMIC EXPANSION AHEAD OF US. THE LAST FEW YEARS HAVE NOT BEEN EASY ONES. BUT, I THINK THAT WE HAVE LEARNED FROM THE EXPERIENCE. BY THE END OF THIS BICENTENNIAL YEAR, WE WILL SEE IF WE HAVE OUR LESSONS WELL IN MIND AND HAVE ACTED ACCORDINGLY.

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