Remarks of Mr. Robert P. Mayo
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to the Planning Executives Institute
Northern Illinois Chapter
September 8, 1977

Thirty months have passed since the low point was reached in the most severe business recession we have had since the end of World War II. The severity of the downturn fortunately has been matched by the strength of the upturn--a business expansion, which, by many measures, has been one of the best on record.

Nevertheless, some of the recently reported economic statistics have not been very promising. Concern has been expressed in some quarters that the expansion is coming to an end and that we are on the verge of a new recession.

- The unemployment rate has remained locked at almost precisely 7 percent for four successive months.
- The index of leading economic indicators has declined for three successive months. While the May and June declines were less than originally reported and the preliminary figure for the July decline was quite small, loyal followers of this index have become pessimistic about the outlook.
- Durable goods orders have failed to show coming strength in capital spending, an expectation which many forecasters expressed when predicting continued strong growth in the coming months.

To a surprising extent, much of the current data and the questions which are being asked about the possibilities for continued economic expansion are similar to those of about a year ago. At that time, the economy

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was beginning to show signs of what has since come to be known as the "pause" in the recovery. Looking back on the relatively slow growth which occurred during the second half of 1976, we can now see that two things occurred. The consumer slowed his spending from the exuberant pace of the first half of the year. In addition, inventory growth in the first half outpaced sales gains and so later in the year we went through a minor inventory liquidation cycle. By late last fall there was no shortage of dire predictions that the recovery had aborted and that we were slipping back into recession. There were calls for a variety of drastic measures to get the economy moving again. With the infallible precision of hindsight, we can now see that the economy was actually poised for very strong progress.

To a major extent, this entire business expansion has been fueled by consumer expenditures, speeding up as consumers loosened their purse strings, slowing down as they became more cautious. The strength of the first quarter of 1977 surprised almost everyone, considering the very severe winter over a large portion of the country. Many economists early this year were forecasting that weather problems would hold growth during the first quarter to below the long-term rate of 3 1/2 to 4 percent. Instead, the most recently available data show that once the worst of the cold was over the rebound was extremely vigorous. Despite the production losses in January, the first quarter growth rate was almost twice the trend rate. The economy's growth in the second quarter, though not quite as strong as in the first, was still extremely good. And the advance was again led by the consumer, both through his return to the retail sales market and through the enormous resurgence of the new housing market, particularly for single-family homes.

Now it would be easy to add to the list of unfavorable current statistics I have already mentioned and join the pessimists in suggesting

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that the economy is, at best, repeating last year's "pause," or even joining those who are suggesting another recession, but I don't think that history repeats itself that exactly. In fact, I think there are significant differences between conditions today and those of 1976 which suggest that a strong case can be made for expecting average or above-average economic growth and further slow declines in the unemployment rate over the next few quarters. But I would be very surprised if the economy were to experience the same sharp growth rate of the first half of 1977 through the remainder of this year or into 1978. In fact, I think that continued growth at the heady first half rate would be less likely to lead to sustained good performance of the economy over the long haul than if we have the more moderate growth I am inclined to expect.

I would like to share with you some of my reasons for thinking that the next several quarters will show good growth rates that are sustainable without overheating the economy.

The capital goods industry has been a laggard throughout the present recovery. However, capacity utilization has been increasing steadily, and pressure is beginning to build in many companies to start moving in the direction of new plant construction. This pressure is already evident in the strong increase in orders for non-defense capital goods, up about 5 percent in June, the fourth consecutive monthly increase. While July orders dropped from the June level, this is an erratic series, particularly hard to seasonally adjust, and the July drop seems almost completely the result of the behavior of the even more erratic transportation equipment sector. In addition, a significantly higher level of defense procurement has been authorized for fiscal 1978 (which starts October 1), and this will be making an impact on orders for defense capital goods later in the year.

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Backlogs of machine tool manufacturers are rising steadily. Housing starts, which have been strong all year, jumped in July, with much of the new strength in the previously depressed multifamily sector. Permit levels suggest that the strength of housing so far this year will continue. Inventories seem under control and, as other capital spending grows, will also be making a contribution to growth. All in all, the entire capital goods area appears ready to contribute a much greater share to sustained growth. But we are unlikely to see a capital spending boom in the immediate future.

Second, the government sector, which had, in constant dollar terms, been essentially stagnant throughout all of 1976 and the first quarter of 1977, seems poised for rapid increase. Federal purchases of goods and services moved up sharply in the second quarter. There are indications that state and local spending is also beginning to head up. The newly authorized Federal funds for public service jobs and public works are beginning to flow into state and local coffers and should be showing up in the economy in the second half. In addition, despite a few real headaches like New York City, state and local governments are beginning to accumulate substantial surpluses as tax receipts reflect the general improvement in the economy. As these surpluses mount, it seems likely to me that the austerity which reigned at all levels from state houses to village halls will relax, for better or for worse, and these surpluses will further add to economic growth. Let us hope the spending reins won't be relaxed too far!

Third, I do not discount the consumer. While worries have been expressed about the recent rapid growth in consumer credit and the low levels of the personal savings rate during the first half, I don't think conditions are comparable to the second half of last year. Then, consumer income,

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adjusted for inflation, was growing very slowly. In the second quarter of this year, the growth was at an annual rate of over 8 percent. This was three times as fast as the growth rate at the same time last year. Furthermore, the decrease in withholding taxes which occurred in June, was smaller than the amount needed to adjust for the 1977 tax change. Refunds next spring are likely to grow by more than the normal amount. The increase in social security payments begun with July's payment, coming increases in Federal pay scales, and generally rising pay levels will all contribute to a continuing strong increase in real disposable income over the next several months. While I do not think this will lead to a boom in consumer spending, I do expect that the consumer will be making a positive contribution to economic growth. He may already have begun to do so. After several stagnant months retail sales turned distinctly upward in July, and figures from major retailers for August are encouraging.

Finally, I am encouraged by the recent news on the price front. The July figure for the consumer price index showed only an 0.4 percent increase, while farm and wholesale prices have been favorable to a more stable price level for two or three months. The battle against inflation is not won, but it does appear that the abnormal increases caused by last winter's severe weather have finished working their way through the economy.

So far I have suggested a reasonably favorable picture of the months ahead, with better economic news than some of the recently released data might suggest

- growth fast enough to see gradual further reduction in the unemployment rate
- yet not a boom which quickly leads to severe price pressures as shortages develop during the months ahead.

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But, of course, we have no guarantees. Future external shocks like the 1974 oil embargo or last January's severe weather could adversely affect the outlook even though the basic conditions for sustained growth are present. And I do not foresee a future without problems. Both the unemployment rate and the inflation rate are uncomfortably high. Both problems have significant structural aspects that are not readily attacked by the conventional moves of monetary and fiscal policy and which will be major challenges over the years ahead.

But let me step back from these longer-term structural problems and retain the focus on the near-term business outlook. As you have undoubtedly noticed, I have sketched an economic outlook scenario for you that has not specifically mentioned monetary policy. Obviously, monetary policy is important and I must, therefore, be expecting that monetary policy will be consistent with this path of moderate growth.

As you are all aware, the Federal Reserve, since 1975, has been reporting to Congress every quarter on the course of monetary policy for the year ahead. The growth paths for the monetary aggregates announced by Chairman Burns on July 29 are entirely consistent with the type of outlook I suggested; M-1 (demand deposits and currency) from 4 to 6 1/2 percent, M-2 (M-1 plus savings and time accounts) from 7 to 9 1/2 percent. They represent the kind of financial developments that have already favored economic expansion.

The economy certainly has not been starved for funds these past two years. Instalment credit has expanded at a significant rate so far this year. Mortgage credit flows have been of record magnitudes. Business firms have placed heavier demands on credit markets. Net funds raised by

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nonfinancial corporations increased by about 30 percent between the second half of 1976 and the first half of this year. Credit demands by state and local governmental units have been very large. About a fifth of the record municipal bond offerings has been devoted to advance refunding of debt issues. The remainder has included substantial amounts to finance construction of public power plants, hospitals, and water and sewer facilities. Only Federal Government borrowing has declined from last year. This reflects both the recovery of Treasury revenues and the shortfall in spending.

The expansion in the economy and the attendent credit demands have been reflected in a rise in interest rates since the beginning of the year. But the increases have been moderate. Certainly the modest proportions of the increases and the lateness in the cycle surprised almost everyone who forecast rates last year. And interestingly, almost all interest rates are lower than they were at the bottom of the cycle.

Recently, there has been another modest spurt in short-term rates. This was followed about a week and a half ago by an increase in the Federal Reserve discount rate. This was not a further tightening move on the part of the Fed as some reported. The increase to 5 3/4 percent was clearly identified as a technical move to bring the discount rate into better alignment with other short-term interest rates.

Unfortunately, on the heels of the weaker economic statistics I mentioned earlier, the recent increases in short-term rates have led to charges that the Fed is tightening up on monetary policy at the wrong time. But the public accounts of developments are showing again the tendency to latch on to the most recent events, ignoring what came before.

Just a few weeks earlier, many reporters were up in arms about the large increase in the money stock. During July, M-1 had grown more than 18 percent

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at an annual rate. The increase was viewed with dismay and we were charged with flooding the economy with money that would lead to a new inflationary binge.

If the press and Congressional evaluations for these two developments--first the increase in the money stock and then the increase in interest rates--had been given at the same time they would have looked silly or at best confusing. Unfortunately, however, explanations are presented in a piecemeal fashion and insulated by time.

The facts are that monetary policy for some time has been committed to a course of adequate but not excessive monetary growth. We believe that course will lead to reasonable economic growth in an environment of reduced price pressures.

Now I am not one who will slavishly follow a fixed rate of monetary growth day in-day out, week in-week out or even month in-month out. You can't operate with such precision. It isn't necessary to achieve your goals for the economy. And if you tried you would create problems for financial markets rather than gains for the real economy.

But there is no question that over longer periods of time excessive monetary growth leads to trouble. Therefore, you must constrain that growth and when you do by reducing the rate at which reserves are supplied, the cost of those reserves--the Fed funds rate--tends to rise. And this also means some increases in other short-term rates.

So, efforts to keep financial inputs coming at a reasonable pace can lead to higher interest rates. Unfortunately, Congress and the community frequently "want their cake and eat it too." They want stable interest rates *and* a moderate pace of monetary growth.

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It may seem paradoxical, but it is true, that efforts to hold back on excessive monetary growth even at the expense of higher interest rates in the near term is the best way of getting lower interest rates and a moderate pace of monetary growth in the future. Excessive rates of monetary growth fuel inflation and inflationary expectations. In turn, inflation expectations push up long-term rates. An inflation premium, as it is sometimes called, is built into the rates. So the strategy is clear. Keeping the monetary aggregates on a more moderate growth path reduces inflationary expectations and the upward pressure on long-term rates.

The recent developments are an excellent example of this. A continuation of July money growth at 18 percent annual rates would clearly be excessive. In an effort to get back on the long-term path, we added smaller amounts of reserves, the Fed funds rate rose and so did some of the other short-term rates. But in taking this action to stem the rate of money growth, long-term rates remained largely unchanged. In other words, the Fed's actions helped to overcome inflationary concerns that would otherwise have resulted in increased long-term rates.

The short explanation then for the financial developments of the recent past is that the Fed was simply continuing to hew to a moderate path of monetary expansion. In that sense, there hasn't been any change in monetary policy.

Should the real economy depart from the course I have suggested, monetary policy would, of course, be changed. But for the near term I would not expect our announced paths of aggregate growth to be inconsistent with moderate continued expansion. Obviously, the result will not be a perfect economic performance but if we can maintain the course we have set, we should be able over the years ahead to make continued progress in our fight to return to economic stability.

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