Remarks of Mr. Robert P. Mayo
President, Federal Reserve Bank of Chicago
to the Fall Conference of YMCA Executives
Rockford, Illinois
October 2, 1979

Our Challenging Economic Future

It is a pleasure for me to be here with you today. I consider it a rare privilege to be asked to open your conference on "Managing a YMCA in a Changing Economic Environment." Your timing in selecting this subject could hardly be more opportune. I think we are, today, on the threshold of change in our economic environment in three important ways.

First of all, in the near view, we are at or near the end of one of the longest peacetime periods of economic expansion in our history. Real growth of the economy turned down in the second quarter of this year, after expanding steadily since the spring of 1975.

Secondly, we are going through a painful re-evaluation of the means available to the federal government for influencing the economy. It has become increasingly clear that the continued use of federal deficit spending to push economic growth has been a major factor in our steadily worsening inflation of the past fifteen years.

Finally, there are even longer-run pressures for change in our economy. Energy, particularly oil, has been the one most clearly in the public eye in recent months. At the same time environmental considerations, changing demography, and world-wide political unrest are among a host of pressures that suggest that the fabric of our economy, indeed our society, may well look very different a decade from now as compared with the way we see things today.

Let us first take a look at where the economy is now. Many economists are already saying that we are in a recession which began in March or April. I'm still not absolutely sure if we are in a recession or not, but we probably are, despite some continuing strong signals of economic well being. Indeed, none of us will know until the Bureau of Economic Research, as the keeper of such records, makes its official pronouncement, probably some time in early 1980. However, I do know, from the data we have, that economic activity has slowed down substantially from the growth rate of last year. The broadest measure of economic activity we have is the real gross national product--GNP--our total output measured in constantly valued dollars. To give you a yardstick for comparison, the long-term average growth rate in GNP has been about 3 percent a year. Over the recent three full years of expansion, 1976 through 1978, GNP grew at an average rate of over 5 percent. During the first quarter of this year it grew very little. During the second quarter it went down. So far the first half of the year we have averaged a small but distinct decline--at an annual rate of about 1/3 of one percent.

Most of this slowing in growth has been caused by the American consumer pulling in his horns. He has bought fewer cars. He has stopped buying refrigerators and furniture and other things where the purchase can be postponed. He has slowed up on his buying because he feels less well off financially than he did six months or a year ago. And he is right. For the average consumer, income has not kept up with the rise in prices, particularly since the beginning of 1979.

Of course, one can point to certain special events which have occurred this year. Certainly the severe winter in the Chicago area, and almost as bad weather in many other large population centers, had a negative impact. The trucking strike did not help matters. The gasoline shortage certainly cut vacation and resort spending. But whenever one looks at the overall business scene there are always special occurrences which can be pointed to as having an impact. The current slowdown is the result of more fundamental factors than these events. It results directly from the long period of accelerating inflation and from government policy steps that are essential if we are to restore reasonable price stability to our economy.

We are now in the fifteenth year of an inflationary cycle. That cycle had its roots in our attempt to simultaneously finance the Viet Nam War and a whole new array of Great Society programs by borrowing rather than by taxation. Now I know that there is a strong tendency to blame inflation--particularly the high rates of the past few years--on OPEC, or the oil companies, or the utilities, or labor, or whoever is the most popular or convenient scapegoat at the moment. But the real culprit has been federal government economic policy. That policy, in turn, is largely molded by the demands of the U.S. public acting through their elected representatives. As the comic character Pogo said, "We have seen the enemy and he is us."

In the final analysis inflation is a monetary phenomenon. When money growth outruns physical output, prices rise. If it's that simple, then the solution ought to be easy: just slow down the growth of the money supply and all will be well. But it is not that simple. To shut off the growth of money abruptly would produce a rerun of the depression of the 1930s--and 25 percent unemployment. We are not starting with a clean slate. The impact of a sudden return to steady low growth of the money supply would produce economic dislocations which would make the recessionary 1973-75 period look like glowing prosperity.

Indeed, you are all aware that monetary policy has never been given a single objective by the Congress--just to maintain stable prices. It has also been charged with responsibility for integrating price stability with employment, economic growth, and balance of payments goals. This has meant that monetary policy has found itself typically in between. We must listen carefully to those that urge maximum short-term economic stimulation so that material progress would be achieved and more jobs created in the short run. We must also listen carefully to those that urge that purchasing power be limited so that inflation would be discouraged and eventually brought under control. Not surprisingly then, monetary policy has not been able to focus single-mindedly on one economic objective, no matter how desirable, when the society has multiple goals. In a democratic society, policy options always tend to produce compromises.

Over the last fifteen years, however, there has been an increasing tendency to attempt to solve all of the nation's problems by a fiscal policy relying heavily on deficit financing. Indeed, the decade of the '70s can be looked on as the decade of the deficit. During every single year of the decade the federal budget operations have resulted in added borrowing. And borrowings for federally sponsored programs not counted in the budget have added significant amounts to the total debt. This string of deficits, together with those accumulated in the late 1960s, has been the primary source of the inflation which plagues us today.

There is a distinct linkage between monetary policy and fiscal policy which is a direct consequence of the political structure of our country. The Federal Reserve System is a creation of the Congress, and is broadly responsible to it. But the Congress was very wise to create the Fed as an independent body--not independent of the government, but independent within the government. Thus while monetary policy has a range of independence, it cannot ignore the economic targets the government wishes to achieve.

The President only recommends a fiscal plan to the Congress. But the Congress has final say over fiscal policy. It controls appropriations and tax legislation. An independent monetary authority which regularly acts to frustrate fiscal policy over any extended time period will fast lose its independence. To that extent monetary policy is tied to fiscal policy. There is no way that the long sequence of deficits of the 1960s and 1970s could have occurred without placing severe constraints on the conduct of monetary policy. The Federal Reserve System had to permit more rapid monetary expansion than it felt desirable. Otherwise the increased public debt could not be successfully financed in a free market without squeezing private credit mercilessly.

So, as a result of a long chain of federal deficits and the financing of those deficits by monetary expansion, we have reached our present rough situation. Today's inflation is the last link in a long chain of well-meant actions. As you well know the road to you-know-where is paved with good intentions. The benefits of tax cuts, of increased public spending, of a faster rate of money growth, may be felt within a few weeks or quarters. The penalty in terms of inflation comes later, perhaps a couple of years later, perhaps even later. Today's inflation is the long-run consequence of the short-run policies of the past.

So that is how we got here. And we have finally arrived at a time when there is widespread public recognition that our primary economic problem is inflation. This recognition has produced a new attitude toward the economy, both in the administration in Washington and in the Congress, not to mention the tax revolt now sweeping the country at the state and local government level. The problem confronting us has become so severe that we seem to be ready to take a longer-term view in seeking a solution. With negative real economic growth in prospect for this year, and perhaps much of next year, and with inflationary pressures intense, I hope that this can be a watershed year for economic policymaking. The traditional national response to a widely expected slackening in economic expansion or recession (commonly thought of as two quarters of negative real growth) would be to reverse the economic policy gears. Thus we would be backing off from immediate deep concern about inflation and starting to pump up the economy again. But, hopefully, the reaction of economic policy to our reaching the watershed in economic performance will be significantly different this time. President Carter has pledged his support to this principle of fiscal conservatism. Let's hope he can still stick with it during his entire term.

Opposition to "knee-jerk" policies--switching to stimulative government policies whenever slower economic growth seemed likely--has, of course, existed among some economic thinkers--and many politicians for a long time. But it has taken the pressure of persistent inflation to bring the majority of our people to the point of making a significant and necessary change in their thinking about economic policy. I think that change has occurred. It was evident in the Economic Report of the President issued early this year. It was evident in the budget that the administration proposed for fiscal 1980. Even more important, despite the OPEC oil price increase this spring and increasingly negative expectations for economic growth for the next few quarters. Congress has adopted the President's basic program of progressively reducing the Federal deficit and the size of total federal spending relative to the economy. In line with this less stimulative fiscal policy, monetary policy is aimed at a very gradual reduction in the rate of growth of the money supply.

With this policy framework in place, I expect negative growth for the rest of this year, and probably into the early part of next year, followed by a relatively slow recovery. However, I confess I do not expect to see any sweeping strides in winding down inflation as much as we all would like to see. The President's wage and price standards program continues to be tested. It is clear that those standards will have to be relaxed somewhat in the light of the higher than expected inflation since they were first introduced. Labor demands will continually try to make up for the price increases that have already occurred. Businesses will have to pass through the added costs, and real profits are still low historically. We are not going to undo fifteen years of excesses with one year of restraint.

There is, of course, a possibility that reductions in the rate of inflation will come somewhat more rapidly as consumers and business firms begin to lose some of their cynicism and accept the view that inflation will, indeed, be constrained over the longer run. The present high rate of inflation has generated responses by individuals and institutions that perpetuate a rising spiral even in periods of economic slack. If expectations change about the future course of prices--even slightly--behavior will also be modified. The name of the game is expectations. The sooner we have confidence that a lower inflation rate is in prospect, the shorter the period will be to bring us closer to reasonable stability.

Undoubtedly, only modest improvement in reducing the rate of inflation arising from slower economic growth can weaken the resolve of the Administration and the Congress and test its patience. The public wants quick solutions. There are none. It will be difficult for the less courageous to continue to accept slower growth and some attendant unemployment increases--in the absence of dramatic price effects. Nevertheless, such a course is necessary.

The biggest danger is, of course, that our political resolve will weaken as the unemployment rate rises and the public becomes restive in the doldrums of a temporarily sluggish economy. The chances for retaining a neutral-to-restrictive policy stance could evaporate if the mild turndown now foreseen turns into a really severe contraction. A deep, sharp recession would bring swift Congressional action to stimulate the economy. Yet such action carries the risk, even the probability, of still higher inflation a year or two down the road.

It is, therefore, extremely important that the public support holding the line--starting now. If we can maintain reasonable fiscal and monetary restraint now, we should be able to make substantial progress toward a more stable, less inflationary economy for the years that follow. We must not be deterred because one year of stringency fails to bring little immediate relief from inflation.

Looking farther down the road into the 1980s my crystal ball becomes even hazier. It is easy to spot problems. It is virtually impossible to foresee how they will be resolved. Some of them may turn out to be real problems at all. I hope it turns out that way. I don't know who the sage was who said that he had spent his life worrying about a lot of things, most of which never happened. That is true for all of us. I think he should have added that he gave no thought or worry to a lot of things that did happen, unforeseen.

I certainly don't want to turn this keynote into a gloom session by reciting a long litany of things that could go wrong. First of all, as I have just suggested, my list would probably be wrong. More important, however, is my belief that, at least in one sense, American history does repeat itself. Over history we have met our challenges. We have solved our problems. I think we both can and will continue to do so. I am inherently an optimist--on human values as well as financial principles.

There is, however, one problem area on which I want to focus your attention, because we are now seeing the initial impact of it in its first stages and because the way we solve this problem can involve drastic changes in American society.

I'm talking about energy. A lot has been said and written about the energy crisis, who is to blame, perhaps that there is no crisis, and so on. I don't want to get into that aspect, but I do want to lay out some of the facts and possible consequences of the situation before you. First of all, I want to separate, to the extent it can be done, the oil problem from the energy problem.

Oil currently supplies a little over 40 percent of our nation's energy requirements. About half of all the oil we use is imported. Oil is a very special source of energy because about half the oil we use is for transportation--gasoline, diesel fuel, or aviation fuel.

In these uses we have little or no means for substituting some other form of fuel in the near-term. Two other facts about oil most enter into our thinking. For the past twenty years less oil has been discovered in the United States than we have produced, except for the Alaska discoveries. Even with Alaskan oil, today's reserves are now back down to what they were before the North Slope discoveries. Whether the current world supply shortage is real or artificial today is really not important. If it isn't real this year it surely will be next year or the year after. Second, our imports, an amount, remember, equal to our total needs for transportation, have been interrupted by political problems twice already in this decade. The obvious immediate result is that we must find ways to stop the growth of oil imports and even reduce our use of oil as an energy source. We must divert it from uses such as home heating and electric power generation, where other fuels can be substituted. We must also reduce the amount we use for transportation. Government rules have dictated that gasoline consumption per mile on new cars be radically reduced over the next several years. If the reaction of the auto market to the recent lines at the gas pumps is considered, however, it may be that the marketplace is going to insist on even better performance than government fiat. Another already visible effect is the return of freight traffic to the railroads, particularly in the western United States where the trackage is in better, but not really good, condition and the railroads operate relatively efficiently. But more basic changes are coming. Today about 85 percent of us drive to work, mostly alone, and we drive long distances to get to our jobs. I think we are going to gradually see a shift toward living closer to work and a return to public transportation. Whether this means a shift back to the central city to live (and work) or to larger, more complete suburban clusters is hidden in the hazy part of the crystal ball.

But what about the rest of the energy crisis. Well here the facts are that the basic supplies are ample. There are enough known coal reserves to supply our energy needs for hundreds of years. Natural gas now seems to have adequate supplies, nuclear fuel in abundant, and given the prospective development of breeder reactors, virtually inexhaustable in the foreseeable future. Why, then, the atmosphere of crisis. Why the run up of costs of these forms of energy if oil is the only energy source for which imminent shortages are a problem. To a large extent I must place the blame for the emotionally charged crisis atmosphere for the whole energy area on the justifiable concern about oil.

It has taken too long for us to realize that we must turn to other sources as substitutes for oil, and the lead times necessary to actually make the shifts are long. Almost as important in bringing about the crisis atmosphere, however, is our relatively recent recognition of the fact that our old methods of producing energy from fuels were seriously disturbing our environment. We can no longer afford to stripmine coal by permanently destroying good farmland. We have to provide for restoration of that land. We have to pay for that restoration. We cannot burn coal without preventing the sulfur dioxide and other pollutants from contaminating the air we breathe. We have to pay for necessary protection. Similarly we cannot expand the use of nuclear power without finding a safe way of storing and handling reactor wastes. Furthermore, as Three Mile Island proved, we have important operational safety problems which demand our attention.

So, despite the abundance of other energy sources, their prices have risen, too. First, because, by agreeing that the environment must be protected, we have added substantially to the cost of using these abundant fuels. But of course there is another reason. The power companies, the natural gas distributors, the other large users of primary energy have been no less affected by inflation over the past fifteen years than has the consumer. Higher wages for everyone all along the line, from coal miner to meter reader, increased costs for construction, higher maintenance costs--all these added to the new environmental costs have to be included in the energy bill.

So, while my crystal ball says that there is no total energy shortage, dislocations, temporary shortages of certain forms of energy and higher costs are readily foreseen. This in turn suggests that society is going to adapt to more frugal use of even those forms of energy which are relatively abundant. We may keep our homes a little cooler in winter and a little warmer in summer than has been our past practice. Again, as with the automobile on gas mileage, not because the Federal Government has asked us to, but because our pocketbooks tell us so in much stronger terms. And this is not going to be just conservation by the consumer. Most of our industrial processes which rely on large amounts of energy have developed around procedures which are not energy efficient in today's environment because it was once so cheap. Now I think process research in industries like steel making, aluminum refining, glass manufacture, even the humble and ancient art of brickmaking, is going to focus on substituting capital equipment and manpower as inputs to replace energy, in some cases reversing the direction of the past 50 to 100 years.

You may have noticed that I have not said anything about either solar or fusion energy. These are two potential sources of a return to abundant low-cost energy which have been widely touted as the sources of the future. Well, the technology for use of solar energy does exist today, but at costs so high that, except in rare instances it cannot compete with conventional sources. When or if our scientists can find ways to make it economic is hidden in the haze. With fusion power all we now have is hope plus faith in the genius of American scientific research. Getting usable energy by this process is still technically far beyond our grasp.

I could go on to describe other areas where I see things that will certainly change American life. The demographic changes which are going to greatly increase the proportion of our population which is over 65 years in age has already begun. The number of young people entering the work force is declining. The use of the oceans, the potential source of many raw materials now in decreasing supply from their present sources, is the subject of long and sometimes bitter but inconclusive negotiations among the nations of the world. The list could go on and on.

In almost every sphere of economic activity there is some challenge to be met. What does all of this mean to the future of the YMCA? It means much more than you may think. The social environment in which you work, the human needs you will be called upon to meet, and--to an extent greater than you really realize--the basic fabric of the American social and economic structure all rest on progressive institutions such as the "Y" and the leadership you bring to it. You are all leaders. It is up to you to provide those who are going to meet these challenges with the courage and confidence to face them. Together we will find the necessary solutions.