LOOKING FOR THE SILVER LINING

by

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When I first proposed the title of this talk to Bill Metz, I had a strong feeling that everybody was overdoing gloom and doom. I'm happy to see that the President in his recent press conference agrees with me. My reading of prevailing psychology, however, is that nobody is convinced that the economy isn't getting worse and gloom is getting thicker day by day. We can't talk ourselves into a happier frame of mind. The important thing right now is to make a realistic, hard-nosed evaluation of both the gloomy and the brighter sides of the outlook and see where we come out. This is what I'd like to do this evening.

Gloom

Business forecasts uniformly are gloomy. Mine is too. Let me run through it briefly.

The mood of consumers is depressed and likely to stay that way. Surveys indicate that consumers are concerned about their jobs and their incomes. They will continue to be very cautious buyers and will be increasingly heavy savers. They will be trying to work down their debts. All this will be reflected not only at department stores—beginning with a lackluster Christmas season—auto dealers and appliance stores, but also should be showing up at banks. Demand for loans will be off and savings should come in strong. Except for the fact that the consumer will be improving both his and your liquidity, I find it hard to come up with anything optimistic on the consumer front.

Housing will stay depressed until the middle of the year. Even then it will recover only very slowly because lenders will want to build liquidity for a while and it will take some time to absorb the overhang of unsold houses.
Inventories will be liquidated. The hopes some of us may have had a while ago that the computer had outlawed the old-fashioned inventory cycle have been dashed by the upsurge in stocks and subsequent need to liquidate them.

Capital spending will be weaker. Despite longer-term needs for more capacity, it is unrealistic to expect industry to keep investing in plant and equipment at the rate of the last couple of years in the face of the kind of recession we are in for.

In the policy area, I see further cause for concern. The new Congress is likely to move more vigorously to solve problems, and that will be good considering the vacuum that presently exists in Washington. But in its zeal to do something, Congress could do some wrong things. The pressure to spend our way out of the recession will be overwhelming. A relaxation in the earlier balanced-budget objective now seems to be appropriate; some tax relief in selected areas probably is appropriate. But the danger of going overboard on spending is great and could contribute to considerable grief later on. By the time the spending would be likely to come on full stream, we will be coming out of the recession and the resulting impact on inflation could put us back where we started.

Precipitous action with respect to controls also is an increasing danger. I detect in the business community another swing toward favoring controls. Memories are short. It was not long ago that the shortcomings of controls were very fresh in our minds. Perhaps controls could be handled better next time, but I see a considerable possibility of an eager Congress forcing a reluctant Administration to inaugurate a blanket of controls that could prove just as burdensome, disruptive and in the end ineffective as those we've already tried.
Finally, on the policy side, there's good reason to be pessimistic about the chances of coming to grips— at least for some time— with the energy problem. The problem is so immense— so many billions of dollars, such a great shift in the balance of power, so many political and economic ramifications— that it is impossible to grasp quickly. But the longer we flounder, the greater the danger that someone, somewhere will do something rash, with disastrous consequences all around.

To wrap up the gloom in one distasteful package, I would summarize by saying that I see us by the middle of 1975 at about the bottom of the worst post-war recession. Unemployment at around 7½ per cent and rising. Prices still going up more rapidly than any of us would like. And a tendency on the policy front to thrash around for remedies that may not only not solve our problems but possibly complicate our lives further in the future.

Silver lining.

Now let's look for the silver lining. It does seem to me that we're getting somewhat carried away with all the "gloom and doom" talk going around these days. When business is booming we don't think it will ever stop, and when it slows down we say we can't see the bottom. In my professional career, I've witnessed five recessions. In each of these as upturn gave way to downturn, optimism has given way to pessimism. And, then, as downturn phased into recovery, so gloom phased into bullishness. Now, as I live through my sixth recession with all its pessimism, I also fully expect to live through my sixth recovery and the returning optimism that will go with it. What I'm saying is that there are dark clouds above us, and they should be taken seriously, but there are some rays of sunshine as well-- and they too should be taken seriously. Let me talk briefly about several of them.
First, we are definitely not going to have a depression. Perhaps it is indicative of the mood of the country even to have to say this. Nevertheless, it is important not to be carried away by fears of something worse than what we will be getting. There are many things policymakers don't know about the economy, but unless we are much more ignorant than I think we are, we do know how to move against depressions. From 1928 to 1933, for example, the Fed permitted the money supply to drop by 28 per cent. That kind of policy today is unthinkable. Also, the Keynesian revolution may not be all some think it is, but it has taught us that fiscal policy can be used effectively to counter major declines in activity. Moreover, we have institutional arrangements, such as deposit and mortgage insurance, that we didn't have in the Great Depression. And the whole social and political attitude of the country is quite different. In short, a depression simply wouldn't be tolerated.

Secondly, our economy has a great deal of natural resiliency. It has much inner strength to bounce back from a recessionary bout. Even now the seeds of recovery are being sown in the midst of recession. One of the drags on the economy is businessmen correcting for excess inventories. Once these excesses are liquidated, current sales will again have to be met with current production—giving a boost to the economy. Another drag on the economy is housing. One factor holding housing back is the scarcity of mortgage funds. But as the economy weakens and interest rates drop, funds will flow back into thrift institutions and in time back into housing—providing another boost to the economy. Still another drag on the economy is poor auto sales. One reason auto sales are down is that people became over extended—too much of their income going for installment payments. But driving the old car another year stores up auto sales for later on as the car gets older and debts get smaller.
The examples go on, but the point, of course, is that recessions are not one way streets headed off a flat earth. Rather, they are one phase of a cycle and the next phase is recovery.

Third, the kind of recovery I am talking about is not likely to produce a sudden renewed spurt in prices. Unemployment will drag out longer than anyone would like—and this is bad. But a gradual recovery is more conducive to long lasting success on the inflation front—and this is good.

A fourth silver lining is that double digit inflation is likely to become single digit for the first time since the end of 1973. We have two kinds of inflation in this country—extraordinary and basic. Extraordinary includes a quadrupling of oil prices, bad harvests, anchovies disappearing off the coast of Peru, and so forth. Basic inflation is caused by past injections of too much money and too loose a fiscal policy. The worst of the oil price hikes are behind us and some cuts may be in the cards. Three bad harvests in a row just seems too much bad luck. As for basic inflation, the slower economy is already having a dampening impact on materials prices. Also, wage gains may not be as high as earlier predicted. Rising unemployment and poor sales are likely to make employers more reluctant to grant large wage demands and employees hesitant to press too far for them. Finally, some productivity gains are likely to occur later in 1975 as the economy begins to recover. So, when you add up the factors contributing to inflation they add to less inflation in 1975 than in 1974 and if we are to be surprised, we are likely to be surprised at the slowdown in price increases.

Fifth, there are encouraging signs that policymakers are paying a great deal of attention to softening the impact of recession on disadvantaged groups. A program of public service employment is in the works. There is talk again of guaranteeing a minimum income. These actions bode well not only for dealing with recession, but also for dealing with inflation. One of the main problems in taking effective action against inflation is the
resulting impact on various social groups. If policymakers can feel more assured that disadvantaged groups are insulated against the extreme effects of unemployment and recession, they can be more confident in moving against inflation.

Here, in short, are some brighter sides of the picture. Although they may not turn your spirits around, they should be given the emphasis they deserve.

**Banking**

I have held out for separate consideration the situation in banking. In looking ahead, I think we should distinguish between liquidity and solvency. Doing this is always risky, of course, because the two are so closely related. Nevertheless, I think our view of the outlook is clarified if we treat them separately.

The biggest problems of liquidity are behind us. Record-high interest rates and very strong loan demand placed severe strain on banks in 1974. Concern about the industry and particular banks made it difficult for some banks to raise funds in the money market. For awhile it looked as though things were really touch and go and the Fed was on a major alert.

We are still on the alert, but conditions have obviously eased. As the economy weakens further, short-term rates are certain to decline further and loan demand will fall off. We should all feel much less nervous about bank liquidity in 1975.

On the other hand, there is still reason to be concerned about the soundness of banks—not the banking system as a whole, but individual banks. In their anxiety to show an outstanding profit, some banks have stretched too
far. Loan losses in 1975 are certain to materialize in large volume as the economy forces some marginal borrowers to the wall. Capital is inadequate in many cases. This is the negative side of the banking picture which the Fed and other supervisors will have to stay very much on top of.

An optimistic aspect of this is that banks seem to have learned some lessons from their experience. Some of the most go-go among them now speak of the need for a pause, for consolidation. Growth has been replaced by other considerations—at least for the time being. Also, the experience of the past year has taught that regulators have some adapting of their own to do. We have learned some things about the economy and about the country's banks in the last few months that should make us better supervisors. We have gained new insights into the management of banks that should enable us to do a better job of identifying problems before they become unmanageable.

In short, bankers and regulators have learned that they have to remain alert and adaptable to changing circumstances, and they've also learned that too much can be made of growth. So, I think bankers will enter 1975 on a firmer footing than they entered 1974.

Federal Reserve policy

Finally, I save for last what all this means for Federal Reserve policy. Obviously, the Fed has a most difficult job in balancing the need to fight inflation against the need to fight recession. This has been said many times. But as the picture for 1975 becomes clearer, the trade-off becomes clearer.

We must be concerned about unemployment. The reduction in the discount rate at the Philadelphia Fed is an indication of this concern. At
the same time, traumatic as it may be, the recession will pass. The longer-term problem of inflation will be still with us. Federal Reserve policy must consider these short- and long-run aspects of the problem.

I believe that monetary policy must ease from the very tight posture it maintained in the late summer. It has already gone a considerable distance. Given the fact that the outlook for the economy now appears worse than we thought only a few weeks ago, and given the fact that monetary policy works with a considerable lag, it would be desirable, in my view, to have money growing somewhat faster than it has been recently. This, of course, would mean lower short-term rates.

Yet I'm also concerned about going overboard in easing. Not only are prices going to be rising too rapidly for comfort, but we are likely to see a very stimulative fiscal policy coming into play in the months ahead. It would be better if both monetary and fiscal policy were not excessively easy.