Research Department
Federal Reserve
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Downhill Racers

The President and his 800 Sherpa guides unfurled the flag at the economic summit, but now they face the more difficult task of leading the economy down from the inflationary heights without tumbling into the crevasse labelled recession. Along the way, they must face a voting public whose mood has been characterized as shifting from sullen to mutinous. According to the latest Gallup poll, seven out of ten persons believe that the economic situation will worsen during the next six months, and almost half expect a 1930's-style depression to develop.

The tone of the Washington summit meeting and the preceding series of minisummits was not as pessimistic as the mood of the general public, but was still decidedly somber. No general consensus could be reached—not surprisingly in view of the variety of conflicting diagnoses presented at the various conferences—and for that matter the discussion frequently veered away from Public Enemy No. 1, inflation, to a host of other evils, primarily recession. Still, the summit meetings provided some momentum behind the Administration's anti-inflation legislative program, due next week, in line with Senator Mansfield's comment, "The time for words, macro or micro or whatever, is at an end."

Causes of crisis

Many participants attributed the severe and protracted inflation to a collection of one-time misfortunes. The lengthy list included: the coincidence of a worldwide business boom; the impact of a series of major crop failures on the world food supply, plus the disappearance of stabilizing crop reserves in this country; the worldwide shortage of industrial materials because of the inadequate capacity expansion of the past decade; the new bargaining power of Arab oil producers after the disappearance of U.S. surplus capacity; and the distortions created by wage and price controls imposed without a fully developed wartime control machinery. In each situation, too, speculative hoarding accentuated the price upsurge.

Other experts blamed the inflation on basic changes in the structure of the U.S. economy, such as the growth of nationwide unions, the increasing concentration of industry, and an overzealous dedication to full-employment policies which put a low ceiling on unemployment and a floor under prices. Many of the participants gave special attention to the maze of government regulations and special-interest legislation obstructing the efficient working of the marketplace. But in all cases, the "sacred cows" under attack continued to graze contentedly in somebody else's garden.

Most importantly, many conferees attributed the severity of the problem to a worldwide conjunction

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of excessively easy monetary and fiscal policies. Governments, by providing too much money and too much stimulus to purchasing power, eventually fueled a worldwide price explosion. The over-long retention of the system of fixed exchange rates created vast flows of funds from the U.S. overseas and made it impossible for other major industrial countries to control their domestic money supplies. (Also, monetary policy in this country suffered from the learning process of switching from the management of interest rates to the management of the money supply.) According to this view, monetary policy remained easy for too long a period, in an effort to accommodate massive budget deficits, and finally was forced into a severely restrictive stance whose fruits are now painfully evident.

Fiscal path

Responding to these varied and sometimes conflicting diagnoses, the President indicated in his summit speech that he would propose fiscal measures against inflation and not follow the difficult path of structural change. But the fiscal path itself is likely to be difficult, given his promise to cut $5 billion from an inflation-swollen budget and also find funds to offset the impact of surging prices on the poor and aged. Some analysts even doubt the possibility of reaching the present projection of an $11-billion budget deficit for fiscal 1975, reasoning that a $20-billion deficit is more likely on the basis of recession-affected receipts and inflation-affected expenditures.

Still, the budget cutting effort seems essential, for reasons detailed by Alan Greenspan, Chairman of the Council of Economic Advisers, in a recent presentation to the House Budget Committee. Greenspan argued that the upsurge in prices has reflected pressures on the Federal Reserve to accommodate much larger increases in the money supply than it would ordinarily sanction. The strongest source of pressure has been the tremendous acceleration in private business' demand for bank loans—the opposite side of the coin from the inability of private business to meet its credit needs in the capital markets. That development in turn has reflected the increasing pre-emption of basic savings flows by various levels of governments. Thus, the critical element in any anti-inflationary program must be a reduction of government claims on private savings flows, through reduced spending by Federal agencies and by off-budget agencies as well.

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Monetary path

Many of the summit conferees recognized the validity of this line of argument, with its corollary of a continued program of fiscal and monetary restraint, but others pressed for an immediate easing of monetary policy in order to forestall a major recession. Federal Reserve Chairman Arthur Burns replied to this argument at the House Budget Committee session, when he acknowledged that "excessive reliance on monetary restraint leads to unwanted side effects that of late have been all too evident." But he emphasized that "a policy of moderate monetary restraint remains appropriate" for a considerable time into the future.

These statements highlight the fact that monetary policy is not an either/or proposition, but rather a sophisticated weapon capable of acting within a broad spectrum from extreme ease to extreme tightness. The money supply (M_1) has increased at a 5¼-percent annual rate so far this year—somewhat below the 7-percent annual rate of the preceding three-year period—and the growth has been even slower in the past several months. In recent weeks, however, Federal Reserve market actions have indicated a more moderate stance, exemplified by a drop since midsummer of over 2½ percentage points in the rate on Federal funds (overnight bank loans of idle reserves). Other policy actions have made the same point, and have been buttressed by Chairman Burns' assertion of the Fed's determination to avoid a credit crunch.

To repeat, the mood of the summit conference was somber, reflecting the widespread belief that inflation is an exceedingly difficult problem that will take time to overcome. But some historical perspective may be useful. The nation has experienced several bouts of double-digit inflation in the past generation, during the World War II period and again briefly during the Korean War. (For example, the general price index increased 12 percent in 1942, was suppressed by wartime controls for several years, but again rose by 12 percent in both 1946 and 1947.) In each case, the inflationary episode eventually came to an end, with the easing of worldwide business-cycle pressures, the expansion of industrial capacity, and the moderation of previously expansionary monetary and fiscal policies. If treated in the same way, the inflation of the 1970's will one day be seen as an unfortunate historical episode rather than a permanent change in the nation's economic structure.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/18/74	Change from 9/11/74	Change from year ago Dollar	Change from year ago Percent
Loans (gross) adjusted and investments*	84,390	+ 332	+7,939	+ 10.38
Loans gross adjusted—	67,838	+ 982	+8,605	+ 14.53
Securities loans	2,314	+1,024	+ 285	+ 14.05
Commercial and industrial	24,005	+ 46	+3,487	+ 16.99
Real estate	19,878	+ 40	+2,358	+ 13.46
Consumer instalment	9,517	+ 26	+ 699	+ 7.93
U.S. Treasury securities	4,030	− 266	−1,196	− 22.89
Other Securities	12,522	− 384	+ 530	+ 4.42
Deposits (less cash items)—total*	81,098	+ 782	+7,381	+ 10.01
Demand deposits adjusted	22,656	+ 686	+1,396	+ 6.57
U.S. Government deposits	841	+ 439	+ 127	+ 17.79
Time deposits—total*	55,573	− 465	+5,059	+ 10.02
Savings	17,673	− 11	+ 118	+ 0.67
Other time I.P.C.	28,657	− 372	+4,812	+ 20.18
State and political subdivisions	5,945	+ 32	− 155	− 2.54
(Large negotiable CD's)	15,250	− 563	+2,788	+ 22.37

Weekly Averages of Daily Figures	Week ended 9/18/74	Week ended 9/11/74	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	102	− 3	+ 33
Borrowings	147	249	86
Net free (+) / Net borrowed (−)	− 45	− 252	− 53
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions Net purchases (+) / Net sales (−)	+1,362	+1,309	−148
Transactions: U.S. securities dealers Net loans (+) / Net borrowings (−)	+1,064	+ 696	+668

*Includes items not shown separately.

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