

# OUTLOOK FOR THE NATION AND IDAHO

REMARKS BY

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John J. Balles

This is my first official appearance before the Idaho Bankers Association, although I've had the pleasure of meeting many of you on other occasions. I'm grateful today for the opportunity to widen my circle of friends amid such delightful surroundings. I only regret that, with my later remarks, I must impart a somewhat somber tone to these proceedings.

Most of my remarks will center on the problems of the national economy, but I would like first to bring you up to date on some of the new developments in the banking field with which we have been associated. The banking scene has changed considerably since our parents' day, and in view of the speed of technological innovation, the industry will change even more rapidly over the next generation. The Federal Reserve System, through its

many operating functions, will have an important role to play in supporting the banking industry during this period of transition.

### **Towards a New System**

One of the major developments at the Federal Reserve Bank of San Francisco last year was the opening of several regional check-processing centers (RCPCs), including those in Portland and Salt Lake City to service the state of Idaho. As you know, these highly computerized operations achieve overnight processing and settlement for checks payable in specific geographic areas. Altogether, more than 50 banks in our District have already changed their deposit patterns to utilize RCPCs, and this has led to a significant growth of check activity at Reserve Bank offices. These RCPCs have supplemented existing systems, such as the statewide check-collection systems established by progressive Idaho bankers in earlier periods. I realize that outlying banks in Idaho have encountered transportation problems under the new set-up, but I am certain that these and other problems will be ironed out over time. RCPCs are only a first step—although a necessary one—in the move towards the payments system required by the future needs of the national economy.

The emphasis on increasing the efficiency of check-handling through RCPCs stems from a real fear that increasing check usage will overwhelm the present payments system. With check volume growing 7 percent annually, the total could rise in a decade to 50 billion checks nationwide. Incidentally, our Reserve Bank alone handled an 11-percent increase in checking activity last year.

Check volume is likely to increase because of both the growth of the national economy and the growth in the number of check users. At the same time, the difficulties of such a system could increase because of the labor-intensive nature of check-handling, involving substantial amounts of paperwork and physical transfers of paper. This paper glut could result in higher user and purveyor costs, reductions in the productivity of financial transactions, and numerous other problems associated with an overloaded system of paper-conveyed payments.

Consider what lies beyond RCPCs, with the eventual adoption of an electronic-payments system. We can envision a single, integrated, nation-wide mechanism for transferring funds, covering all types of transactions from the automatic depositing of wages and salaries to the preauthorized debiting of regularly recurring payments, along with millions of current transactions. The latest straw in the wind is the Treasury's proposal for the direct depositing of social-security payments at financial institutions, eventually by electronic means; without such a step, the Treasury by 1980 would be involved in some 600 million individual social-security check payments a year. Further, we can visualize the development of a series of card-activated, computer-directed communications networks, linking financial institutions to business firms' computers and retail stores' point-of-sale terminals. Today's RCPCs and automated clearing houses could provide the basic foundation for the eventual nationwide network of such systems.

One of the necessary procedural steps in this path towards a new payments system

was last year's proposal by the Board of Governors to revise the Federal Reserve's Regulation J. The Board received a voluminous amount of mail regarding this Regulation J proposal, with many of the correspondents suggesting that the Fed should move with caution in the area of electronic funds transfer.

Consequently, Chairman Arthur Burns recently notified the Senate Banking Committee that the Board supports the formation of a Presidential Commission to review various aspects of the payments mechanism, generally along the lines proposed last March by New Hampshire's Senator McIntyre.

The Commission would study the means by which individuals, businesses, financial institutions and government agencies could participate in an electronic payments system, including such problems as allocation of operational costs, competitive aspects, and safeguards for personal privacy and security. This vast and complicated subject requires just such a high-level study. But I hardly need to remind you that this is a fast-moving field, and that it deserves your closest attention.

### **Major Long-term Problem**

Your future profits will be strongly affected by the various developments that will occur as the new payments mechanism gradually moves into place. But a number of other developments, especially in the economic field, obviously will be more critical for you in the period just ahead. You needn't fear, as so many did last winter, that a cumulative downturn in the economy will destroy the earnings prospects of your customers and yourselves. However,

in your forward planning, you should look realistically at the nation's major economic problems, both in their domestic and international aspects.

In particular, you should be concerned about the severe and protracted problem of inflation—one of the most difficult economic problems in the nation's history. This inflation threatens to destroy all the hopes we have of regaining the prosperity levels of recent years. And in the words of Federal Reserve Chairman Arthur Burns, "If long continued, inflation at anything like the present rate would threaten the very foundations of our society."

You're already familiar with some of the unique factors that helped cause our present inflation, so I'll review them only briefly. During 1973, a business-cycle boom occurred simultaneously in this and every other major industrial country, and because of this synchronized upsurge in production, the prices of labor, materials and finished goods were bid up everywhere. In addition, disappointing crop harvests the previous year forced a sharp run-up in food prices through most of 1973, while the price and production policies of the oil-exporting countries brought about a dramatic rise in energy prices last winter and fall. More recently, a price bulge has developed with the removal of wage and price controls.

Worse still, these special factors only magnified an underlying bias toward inflation found in this and every other industrial nation. People want the good things of life and they want them now, generally turning to government when they cannot obtain those things through their own efforts. The public nowadays

expects the government to maintain a prosperous economy, to ease the burden of job loss or illness or retirement, and to sustain the incomes of farmers, homebuilders and other segments of the economy. But in the rush to realize these goals—again I'm quoting Chairman Burns—"governmental budgets have gotten out of control, wages and prices have become less responsive to the discipline of market forces, and inflation has emerged as the most dangerous economic ailment of our time."

To show the pernicious effects of inflation, consider the havoc created in the world's financial markets by the increase in price of a single major commodity, petroleum. This development has placed more severe strains on the world's monetary system than at any time since World War II. For the U.S., Europe and Japan, the oil-import bill will be roughly \$50 billion higher than in 1973, contributing to a \$100-billion investable surplus for the oil-exporting countries by the end of the year.

It could be said that a decision by the OPEC countries to export oil at today's high prices is equivalent to a decision to invest huge sums of money abroad, especially in view of their very small domestic markets for imported goods and services. The oil exporters apparently have demonstrated a preference for investing in the Eurocurrency market, which is a highly efficient mechanism for financial intermediation. Nevertheless, that market has certain obvious defects under present circumstances. Funds placed in the Eurocurrency market tend to be on short-term deposit, while the debts required to ease the payments

strains of oil imports will need to be relatively long-term. Moreover, serious financial instability may well result from sudden and massive shifts of funds out of particular money markets and across currency lines.

### **Outlook for Prices and Production**

The GNP price index rose at an 11½-percent annual rate—an unprecedented peacetime increase—during the first quarter of this year, and the rate was even higher after adjustment for the soaring price of imports. The increase, of course, was concentrated in the food and fuels categories. Consumer food prices rose at a 15-percent annual rate—somewhat below last summer's peak increase—and energy prices jumped at a 67-percent rate—several times any earlier increase. Recent improvements in the supply situation for food and fuels suggest that these sectors will be less critical during the rest of the year. In fact, the wholesale price index rose at an 8.7-percent annual rate in April and the consumer price index at a 7.4 percent rate. Even so, any improvement in these areas may be offset by the drive on the part of basic materials-producing industries to cover sharply rising labor costs and to enlarge long-depressed profit margins.

Basic wage increases have not been as high as might have been expected for such an inflationary era. During the first quarter, wages and fringe benefits increased at a 6.9-percent annual rate in major contract negotiations—not much higher than the 1973 average. But labor's increasing emphasis on escalator provisions for both wages and pensions—and "uncapped" escalators at that—creates the danger of a vicious circle of rising prices and wages.

And even with the total wage bill kept under control, any decline in productivity (such as we encountered last fall and winter) could send unit labor costs soaring. Under the impact of bottlenecks and market distortions, unit costs increased at an 11-percent annual rate over that period—twice as fast as in most of 1973—and that type of inflationary pressure is continuing.

Wholesale prices of industrial commodities rose at a 29-percent annual rate in the several months prior to the lifting of controls, and the increases since then in steel, aluminum and other basic industries have been equally large. We can hope that the initial bulge of post-control increases will soon disappear, and that the spiral of price increases will begin to contract rather than expand further. But to do this, we must curb speculative excesses wherever they appear.

According to a forecast prepared by my economics staff, prices are likely to rise by 8½ percent for the year. Bad as that is, it still represents a significant deceleration in the price trend in contrast to the first quarter's 11½-percent rate of increase. As for production, real output may show no increase at all for 1974 as a whole. However, that suggests a noticeable improvement in the second half, following the 6-percent rate of decline in the first quarter and the generally sideways movement of the present period.

The major areas of strength in the outlook are business spending for new plant and equipment, as well as inventories. Government spending should rise considerably—in Washington, and also at the statehouses and city halls. However, the expansion will be held in check by

weakness in several consumer-oriented sectors, especially autos and other durable goods and (in particular) new residential construction.

Business spending for new capacity will be the driving force behind the national economy this year and for several years to come. New plant and equipment should increase at least 13 percent this year, despite the continuation of shortages of certain parts and materials. As evidence, new orders for capital goods have jumped 50 percent over the past year—the sharpest increase since World War II. There is a crucial need to build up capacity in petroleum, steel and other basic materials-producing industries, which have been operating close to the theoretical limits of capacity for over a year.

The neglect of these basic industries dates back to the period of excess capacity of the 1960's, but investment continued to lag thereafter because of the inhospitable atmosphere created by a recession, price controls and environmentalist pressures. The need for new capacity then became obvious when the double devaluation of the dollar limited the sales prospects for foreign goods in this country while creating a vast demand for American goods overseas. The stage thus has been set for a massive business-investment boom, although the financing for this boom will remain questionable until business firms raise their profit margins above the low levels of the late 1960's and early 1970's.

The strong prospects for business spending are not likely to be matched anytime soon by the consumption sector. Consumers were in a recession during the final quarter of 1973 and the first quarter of

1974, with a 4-percent rate of decline in real spending, and the recovery from that slump may be moderate and somewhat prolonged. The consumer has seen his rising take-home pay completely eaten away by inflation over the past year; he has seen his real wealth decline because of rising prices and a sliding stock market over the past half-decade; and on top of that, he has been confronted with a huge overhang of debt resulting from the spending spree of the past several years. He is thus likely to remain in a cautious mood for quite a while, especially when considering purchases of big-ticket items such as autos and household furnishings.

The other weak spot in the outlook is housing. Dollar spending in this sector could decline 14 percent this year, compared with last years' 7½-percent increase. But in real terms, the slump should be somewhat steeper. Real spending declined at a 33-percent rate in late 1973 and early 1974, and the upturn originally projected for the second half of the year has now been endangered by sharply rising mortgage rates and the withdrawal of savings funds from mortgage-financing institutions. Some help will come from the Administration's plan to subsidize a potential 300,000 new and existing units, through below-market interest rates. Even so, a sustained recovery in housing is not likely until the inflation menace is somehow overcome. As things stand, many builders fear that the soaring prices of land, labor and materials could relegate the single-family home to the status of a museum piece.

### **Outlook for Idaho**

Having discussed the problems of the

national economy, I find it a pleasure to turn to the relatively bright prospects for Idaho. This state's future is closely tied to some of the fastest-growing national industries, such as agri-business and metals, so that it can anticipate a strong growth trend for the next several years. It is thus not at all surprising that employment here grew faster than the national average in every single sector of the economy during 1973 and early 1974, and that the jobless rate remained stable even though the labor force expanded at twice the national pace.

The continued high level of domestic and foreign demand should boost farm cash receipts by 40 percent, for another spectacular year. Net incomes may rise at a somewhat slower pace because of cost pressures, but the prospect remains stronger than for farmers nationally. Gross livestock receipts, the leading source of farm income, should strengthen despite some price softening, as feeding operations continue to hold up well in contrast to a decline nationally. Wheat receipts should reach a new high, despite the recent fall in prices, because production could be 45 percent higher than last year's bumper crop. Potatoes, the number one crop, should benefit from excellent weather and prices over double those of a year ago. And all of this bodes well for a continued expansion of the important food-processing industry.

The metals scene is unbelievable, since the dollar volume of production this year could rise 40 percent on top of last year's 30-percent increase. Strong price increases for Idaho's metals reflect a combination of surging worldwide demand and supply problems created by bottlenecks

and environmental restrictions. Prices of lead, zinc and copper, despite strong recent increases, are still only a fraction of foreign price quotations, suggesting the continuing high level of demand for those products. Silver of course is a special case. Its price doubled early this year to \$6.70 an ounce, as speculators fled from currencies to precious metals in their efforts to hedge against universal commodity inflation and the turmoil in international financial markets. The speculative boom has since subsided somewhat, but silver's price remains several times higher than the traditional \$1.29-an-ounce monetary value.

Even the lumber industry appears to be in relatively good shape, considering the rather poor prospects for the housing industry nationwide. Part of the explanation lies with the high level of nonresidential building in this area, as well as the considerably better-than-national performance of Idaho's housing industry, which reflects the strong pace of general business activity in the state. The same can be said for mobile-home sales, which have risen here in contrast to fairly sharp declines elsewhere throughout the nation.

I would guess that tourism will continue to expand, assuming that adequate gasoline supplies are available. Tourism should benefit from the attraction of the nearby Spokane World's Fair, so that you should better last year's record of six million visitors. I would also guess that as more and more tourists come, many of them will decide to stay because of Idaho's natural beauties and expanding economic opportunities. But as Governor Andros has said, the people of Idaho want growth

to occur "in a planned way that embraces the quality of Idaho life."

### **Policy Problems**

The outlook for the state and the nation is dominated by the need to expand basic industrial capacity, so as to reduce the severe inflationary pressures which now confront us. The choice of policy weapons thus depends upon how well they support the necessary expansion of supply, and how well they curb excessive demand. By this standard, direct wage and price controls clearly fail, because of the distortions and bottlenecks they have created over the past several years. Controls were a noble experiment, but like that other noble experiment of a generation ago, they will be remembered only for the terrible hangover they generated.

On the fiscal side, we must keep the Federal budget under control so that it doesn't aggravate our serious inflation problem. Congress should strongly resist pressures for a tax cut, which would stimulate demand at a time when the correct policy prescription calls for a strong expansion in supply. Restraint is doubly necessary because a substantial amount of fiscal stimulus is already included in the fiscal 1975 budget, with a projected deficit of at least \$11½ billion. This follows a \$3½-billion deficit in the fiscal year now ending—a period of unprecedented peace-time inflation. More broadly speaking, it is very discouraging to look at the record of fiscal policy of the last fifteen years in terms of its contribution to economic stabilization. In the entire period 1961-1975, a surplus appears in only year (1969). All other years show deficits.

Monetary policy has a difficult role to play because of the distortions created by inflationary pressures in the real economy and in the credit markets. The Federal Reserve intends to encourage sufficient growth in supplies of money and credit to finance an orderly economic expansion, but not to accommodate a further inflation. To this end, the growth of the money supply has decelerated in the last several months, after a bulge late last fall and again in February and March. Over the past twelve months, the money supply has increased about 6½ percent altogether.

Yet monetary policy has had to contend with a fantastic rise in business demand for short-term credit. Commercial-bank business loans increased at more than a 25-percent annual rate in the first four months of this year, and the pressure was eased only slightly by a slowdown in mortgage and consumer loans. Business-loan demand was stimulated by increased financing for new plant, equipment and inventories, and also in recent months by a shift away from the commercial-paper market and into the banks. Loan increases incurred because of capacity-expansion requirements were to be welcomed. Increases incurred because of the higher costs of doing business in an inflationary atmosphere were understandable, although not welcome—but those made because of speculative inventory purchasing and other purposes should have been rejected. At any rate, thanks to rising prices and soaring loan demand—along with the market's expectation of a sharp monetary-policy response—we have witnessed a sharp and surprising upsurge in interest rates. Within three months' time, the prime

business-loan rate rose almost three percentage points to an unparalleled 11½ percent, before easing off last week.

The capital markets have also been under heavy pressure, even though many corporate and government treasurers have scaled down or postponed scheduled bond issues. The situation has not been helped by the very large financing needs of the housing agencies, and in particular, by the concern aroused by the Con Ed and Franklin National episodes. Thrift institutions meanwhile have suffered substantial outflows of funds, reflecting the rise in rates of various market instruments—witness the sharp increase in noncompetitive tenders at Treasury bill auctions and at the May refunding of longer issues.

Many market participants have feared a further upsurge in interest rates as a consequence of the recent reduction in money-supply growth. But their fears may be largely unfounded. Many borrowers this spring saw the earlier rise in the money supply as presaging both increased inflationary pressures and a tightened policy response, so they borrowed as much as they could, creating excess demand for funds and pushing rates even farther upward. These expectational factors could just as well change in the other direction, causing short-term rates to fall because of the belief that inflation was coming under control. In addition, any slowdown in inflation should reduce the massive increase in the replacement cost of inventories, and thereby reduce the need for borrowing to carry larger stocks.

At present, we have a difficult role to play, but so do you. There's a new word to

describe your task—"de-marketing," which means cutting back the demand for your product during a period of shortages. You must make sure that your stock in trade is used only for the most essential purposes, concentrating on those sectors that will expand the nation's productive capacity. This approach may make funds both scarce and expensive for many of your good customers, but at this juncture, it seems essential that you rein in the demand for loans.

The greatest need in financial markets today is discipline, and you are the people who must instill that sadly lacking quality into current business activity. Admittedly, part of the problem has been caused by corporations turning to banks for the money they would ordinarily raise through the sale of stocks, bonds and commercial paper. And as I've already said, some of these demands must be met, to help meet the nation's future needs. But those who come to you with other proposals, no matter how attractive, must be forced to lower their sights or even to withdraw completely from the market.

If you follow the business press at all, you'll realize that I am not alone in making this plea for sanity. One publication recently editorialized, "The nation's commercial banks are heading down a dangerous road. In their eagerness to accommodate old customers and build new business, they are pushing out loans at an unsustainable rate and trying desperately to attract deposits to cover them." Here is another comment, "In the push to expand, banks have taken more and more risks and devised more and more ways to stretch the regulations"

—followed by the ominous note, “No bank officer under 45 years old today can even remember 1933.”

And here is a welcome note of caution from Arthur Snyder, President of the Bank of the Commonwealth of Detroit: “As a matter of public policy, bankers are expected to be different from the ordinary business man. They are affected with the public interest; they are the guardians of the liquid assets of millions of families and businesses. The essence of being a banker is to stand apart from the excitement and to serve business and the community without joining in business activity.”

### **Concluding Remarks**

To conclude, there's no blinking the fact that the nation is going through a very difficult period. Economic activity seems to be slowly improving, but at a somewhat fitful pace because of serious supply constraints. The price trend seems to be decelerating, helped along by the prospect of bumper crops as well as new productive capacity in industry, but again, the improvement occurs at a maddeningly slow pace. Productivity continues to stagnate because of the problem of bottlenecks, and profits gains thus remain limited, at least after adjustment for inflation.

Nonetheless, we are moving in the right direction, especially since new capacity is being built that will permit the economy to return to its historical growth trend. Monetary policy has been formulated to assist that movement back to trend, and meanwhile to squeeze out the inflationary excesses developed in recent years. At the same time, in its role as lender of

last resort, the Federal Reserve has shown that it will not permit disorderly conditions to develop in the credit markets. Over time, with the cooperation of the banking and business communities, the return to a period of healthy growth should be assured.



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