PROSPECTS FOR THE FINANCIAL MARKETS

REMARKS BY

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

Utah Bankers
Association Convention
Sun Valley, Idaho
June 20, 1975

John J. Balles

I am delighted to join you here in this newly annexed suburb of Salt Lake City. I'm happy also to see so many familiar faces in the audience, including some who were present when I spoke to the Salt Lake City Chamber of Commerce last month. That group may recognize the tune you'll be hearing today, although it will be in a somewhat different key than before. My message, in other words, is that the business statistics are more upbeat now than they were in late winter and early spring, although the same general forces are continuing to operate in the national marketplace.

I'm impressed by the March turnaround in the index of leading business indicators, and especially by April's record increase in that useful indicator of future business conditions. A similar harbinger of recovery is April's upsurge of new orders, especially for durable goods. I'm also impressed by the improvement in the price trend, with consumer prices rising at a 5-percent rate during the spring months, or less than half as fast as they did last summer and fall. Of course, I don't have to remind this audience of the favorable trend in the price of money. In conjunction with a weaker demand for funds, Federal Reserve policy actions—including aggressive open-market operations, several reductions in reserve requirements, and five reductions in discount rates—have contributed to a substantial decline in interest rates. For example, the Fed-funds rate has dropped from a peak of 13¾ percent to about 5½ percent, while CD rates have fallen from about 12½ percent also to 5½ percent.

These and other statistics suggest that the worst of the recession is behind us, although we may be plagued by a high level of unemployment for sometime to come. Most observers expect a recovery to get underway this summer, and I see no reason to quarrel with this view. A great deal will depend on improved consumer confidence. We have seen a severe decline in demand and a consequent buildup of producers' inventories, caused to a large extent by prices rising faster than incomes and eroding both consumer purchasing power and consumer confidence. Consumer after-tax income, adjusted for prices, fell 6 percent between late 1973 and early 1975. But now, the double impact of a declining rate of inflation and a smaller tax bite should soon turn consumer spending around, although possibly with a lagged and weaker response in autos and housing than has typically been the case.

In response, businessmen should begin ordering more inventory, cautiously at first and then more confidently. This in itself would be a substantial boost, in contrast to what happened in the first quarter, when the shift from inventory buildup to inventory run-off reduced GNP by $36 billion, at an annual rate. At the same time, the investment tax credit, when added to the quickening pace of consumer demand, should encourage businessmen to expand their capital-spending plans. If we have written the proper script, the economy can return to a 4-to-6-percent rate of growth in late 1975 or 1976.

Fiscal Policy and Deficits

The business turnaround is now getting massive support from the Tax Reduction Act of 1975. The impact is concentrated in the present quarter—almost $51 billion, at an annual rate—and it then tapers off later on. But the tax cut, the recession-caused decline in revenues, and a number of increases in spending programs, together are creating an unparalleled deficit in the Federal budget. The latest budget review projects a combined deficit of $103 billion for the two fiscal years 1975-76, and the figure could be somewhat larger if Congress fails to go along with Presidential proposals for cutbacks in spending programs.

This is the point at which the new Congressional budget committees enter the stage. Up to now, the Federal budget process has been quite deficient, with all types of spending decisions handled in piecemeal fashion and with an almost-complete separation of spending plans and revenue plans. Now Congress is beginning to integrate these two types of decisions, and if the proper follow-through is achieved, we can expect a much healthier economic environment in the long run. The two Congressional budget committees have recommended spending and revenue targets for fiscal 1976, but those recommendations are not binding this year, since the full budget-reform process will not be effective until fiscal 1977. Unfortunately, we're faced with an immediate problem, since Congress' *current* actions will provide the crucial make-or-break decisions for financial markets in the coming year.

Indeed, the fiscal 1976 deficit may range anywhere between the $60 billion proposed by the Administration and the $100 billion advocated by Mr. Meany of the AFL-CIO—a striking prospect when we remember that the entire Federal budget didn't reach $100 billion until the early 1960's. Moreover, according to Secretary Simon's figures, the recession may be just about 75-percent over, but the Treasury's borrowings to finance the two-year deficit are only about 25-percent completed. Indeed, new cash borrowing from the public could exceed $80 billion in both calendar 1975 and calendar 1976.

Can the financial markets handle these heavy borrowing requirements? Yes they can; after all, that's what markets are for. But depending on the size of the deficit, there could be severe consequences for the private sector. It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But if the deficit substantially exceeds the Administration's $60-billion target, we are likely to see total credit demands rapidly outrunning supply, so that interest rates are driven higher and some private borrowers are crowded out of the market. This "crowding out" of private investment by government spending will in the short run slow the cyclical recovery and in the long run lower the growth potential of the economy. (A single *Wall Street Journal* editorial on that subject has been reprinted at least a half-dozen times in the Congressional Record, and I hope it has been widely read by its intended audience.)

Moreover, there is a long-run risk on the inflation side. Some observers suggest that the Federal Reserve should operate so that all borrowing demands (both Federal and private) can be met at stable or declining interest rates. Such an approach, by flooding the markets with liquidity, could prevent current credit-market strains but at the expense of fueling renewed inflation when the recovery gets underway.

Problems in the Municipal Market

The markets must deal with some other difficult situations, especially the problems of New York and other municipalities. State and local governments have seen their finances mangled by the same forces of recession and inflation that unbalanced the Federal budget so severely. Worse still, the crisis was largely unforeseen in the euphoria that greeted the advent of the massive Federal revenue-sharing program several years ago. But now the combined operating budgets of these units have shifted from a $10-billion annual surplus in late 1972 to an $11-billion deficit in early 1975, reflecting unexpected spending increases and just-as-unexpected revenue declines.

This situation of course increases the borrowing pressures in the municipal market at a time when important investors, for a variety of reasons, have been dropping out of the market. Commercial banks, normally the largest purchasers of tax exempts, now have greater offsets to taxable income than in earlier periods, and hence don't need as much tax-exempt income from municipals. These offsets include some of the increase in loan-loss reserves which many banks have arranged as a result of the recession, as well as the effects of lease financing, overseas operations and other alternative sources of tax exemption. Besides, in this period of uncertainty where some municipals are in danger of default, many banks logically prefer to rebuild their portfolios mainly with the safest possible investment, U.S. Treasuries. With all these pressures, municipal yields generally have remained quite high, and a two-tier market has developed with yields on lower-quality issues reaching eye-boggling levels. In one case this spring, before New York City was forced completely out of the market, it paid 8.69 percent—about two percentage points above the average yield—on a new note issue.

Mortgages and Consumer Debt

The mortgage market of course has its own problems, even though the potential supply of mortgage funds has increased from last year. The usual housing upturn is late in arriving in this recession period, largely because of the saturation of the market during the earlier building boom and the soaring cost of home ownership, which has placed the average-priced new home out of reach of more than half of the nation's families. Basic demand should improve as consumer incomes increase and as the unsold housing inventory is worked off, but the upturn may still be fairly mild.

In the face of these developments, funds have been pouring into mortgage-lending institutions, reflecting the sharp decline in market rates and the continued high rates offered by thrift institutions. In March, for example, total inflows to S&L's reached an all-time high. As yet, however, the thrifts have not fully utilized these inflows of funds, since their mortgage holdings have grown only about as fast as they did during 1974. These institutions instead have largely used their new-found funds to build up their depleted liquidity, perhaps because of an underlying fear that any crowding-out phenomenon would hit them first, and once again drain them of their interest-sensitive deposits.

A mood of caution also dominates the consumer instalment-credit market, reflecting such factors as the auto-sales slump. In late 1974 and early 1975, consumers liquidated outstanding bank debt at the highest rate in a generation. They responded to the decline in their real incomes by reducing big-ticket purchases (and related borrowing), and at the same time, by continuing to pay off debt at a rapid rate.

The consumer-credit market should expand again as confidence picks up and incomes rise, and also as the burden of household debt is further worked down. But we may not see again the massive debt accumulation of the early 1970's, especially in view of the continued weakness of the crucial auto market. We may even witness a slackening of the rapid growth of credit-card usage, somewhat below the 20-percent growth of the past year, reflecting increased consumer caution as well as tighter bank-lending standards.

Corporate Financing Shifts

Corporations, which normally account for about half of all funds raised in credit markets, are unwinding this year from all the inflationary distortions created during the early 1970's. In that period, with after-tax profits growing far more slowly than assets, and with depressed stock-market prices deterring the sale of new equity, corporations relied more and more upon debt to finance their activities, and within that total, they shifted massively toward short-term debt. Between 1971 and 1973 alone, bond and equity financing declined from 21 to 9 percent of total credit-market financing, while the bank-loan share jumped from 6 to 21 percent. This situation of course continued into 1974, when there was a partial shutdown of the long-term market related to the uncertainty of holding bonds in a period of soaring inflation.

The improved price situation this year provides the opportunity for a shift back toward the more normal longer-financing pattern. Corporate-bond issues during the first quarter averaged a record $4 billion a month, and this record pace has since continued, while some hardy corporate treasurers have even dipped their toes into the equity market. Part of the proceeds from long-term debt issues, and part of the proceeds from reduced inventory financing, have thus become available to repay short-term debt, especially at the banks. For the most part, corporate managers are not trying to raise net new money, but rather are restructuring their capital with greater dependence on longer-term sources of funds.

Banks and the Federal Reserve

The banking system of course has been

experiencing the other side of this financial restructuring—the heavy run-off of bank loans. Large commercial banks nationally have incurred a 5-percent decline in business loans to date this year, compared with a 10-percent increase in the year-ago period, and similar shifts have occurred in other loan categories. In the present conservative mood of bank managers, this decline in loan demand has provided room for a runoff in volatile CD funds, as well as a buildup of Treasury security portfolios.

At the peak of the boom, banks played an important role in meeting the demands for funds which other traditional sources could not accommodate. The banks did an admirable job under difficult circumstances, but some of them were left in an over-exposed position. The present drive to rebuild capital and the reduced reliance on volatile sources of funds represent a healthy return to more traditional banking practices. In fact, in their present improved liquidity situation, banks generally are in good shape to help meet the necessary credit needs of the business recovery.

The Federal Reserve's delicate task is to provide ample liquidity for a recession-beset economy while continuing the struggle to bring inflationary excesses under control. Chairman Burns spelled out the details of current policy thinking in his appearance before the Senate Banking Committee last month—the hearing held in connection with the Congressional Resolution requesting information on the Fed's monetary expansion plans. He stated that policy was designed to bring about an increase in the M_1 money supply of between 5 and 7½ percent over a twelve-month period—the maximum now considered to be a non-inflationary expansion in the context of the current economic outlook.

Chairman Burns made two other points that are worth noting. First, this rather high rate of monetary expansion is not too high when so many of the nation's resources are still unutilized and when so many financing needs still reflect rising prices. Second, as the economy returns to higher rates of resource utilization, the rate of monetary expansion will have to be lowered in order to lay the basis for a lasting and non-inflationary prosperity. This necessary balancing of objectives fits in with the Congressional Resolution, which (I'm happy to note) emphasizes stable prices as a goal coordinate with maximum employment.

Concluding Remarks

To sum up, the economic outlook is for an upturn in the second half of this year. But it should be a relatively modest recovery at the outset, especially in view of the continued difficulties of the crucial auto and housing industries. A key factor determining the speed of the upturn is the rate at which manufacturers and retailers work down their excess inventories and prepare the ground for an expansion of orders.

The financial outlook is for a gradual increase in the credit demands of the private sector. How the market handles these demands depends critically on the size of the Federal deficit. Even with the deficit at the lower end of the range I've mentioned, there could be periods of market congestion as the year goes on—aggravated not only by Treasury needs but also by municipal-financing problems. And there will certainly be a major question mark to face as the economic expansion generates new credit demands in 1976 and 1977.

A key factor determining the possibility of non-inflationary expansion amid viable credit markets is our ability as a nation to curb over-rapid accumulation of debt, which has more than doubled over the past decade. Congress must deal with that question in coming months, since it is the sharp upsurge in Treasury debt which now stands out as the largest threat to our anti-inflationary policy measures and to the stability of financial markets. Fiscal responsibility is more than ever a necessity as the nation enters its bicentennial year.