

THE ECONOMIC SQUEEZE

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It is good to have this opportunity of discussing some of the nation's economic problems with this group of farm equipment dealers. Having spent a number of years both here and in Missouri in the farm credit business, I can appreciate the importance of farm equipment distribution to the nation's economy. But more to the point of this discussion, I also recognize the importance of credit in farm equipment sales.

The farm equipment industry is one of the more dynamic sectors of the nation's economy. Capital expenditures for farm machinery in 1966 totaled \$4.8 billion. This was \$2.1 billion, or 75 per cent greater than such outlays in 1960 and more than 10 times the value of similar outlays in 1940. With this vast interest, your concern with public policies that may have an influence on agriculture is understandable. Thus, it is to these policies that I will direct most of this discussion.

In order to provide an appropriate setting for public policies relative to economic activity, I shall review the course of our economy since the current upswing began in early 1961. In this review I have

divided the seven years under discussion into four sub-periods,
1961 through 1964, late 1964 to early 1966, early 1966 to late 1966,
and late 1966 to date.

During the first period, 1961 through 1964, steady economic expansion occurred. As a result, unemployment was reduced from about 7 per cent of the labor force in early 1961 to less than 5 per cent in late 1964. Industrial plant utilization rose from 75 per cent to 86 per cent of capacity. These gains were accomplished in an orderly fashion without great frictions, shortages, or imbalances, and the trend of prices did not deviate substantially from a 1.5 per cent upward trend rate.

Major tools of economic stabilization were moderately stimulative in this period of balanced economic expansion. Growth in the money stock of the nation was at a 2.7 per cent annual rate compared with an average 2 per cent rate in the previous decade. The influence of fiscal actions (government expenditures and taxes) on the economy became more expansive.

During the second period, from late 1964 to early 1966, the pace of economic expansion quickened. This period was marked by the acceleration of military purchases for Vietnam. Total spending on goods and services rose at a 10 per cent annual rate. Most of the increase in spending was matched by a 7.7 per cent rate of gain in

real output. The rapid expansion in output further reduced unemployment from about 5 per cent to less than 4 per cent of the labor force and increased industrial plant utilization from 86 per cent to over 90 per cent of capacity. Prices rose at the somewhat faster 2 per cent annual rate from late 1964 to early 1966, but considering the rise in total demand, the rate of inflation was less than might have been expected.

Fiscal and monetary actions were very expansionary during this period. The Federal budget became more stimulative. It moved from a surplus of \$6 billion in 1964 to a near balance in early 1966.^{1/} The monetary authorities provided reserves to member banks in order to avoid a sharp tightening in credit conditions in response to the strong credit demands. The reserves provided for a rapid expansion in commercial bank credit. This, in turn, caused the growth of money to accelerate. The rate of gain in the stock of money rose from the 2.7 per cent rate in the earlier period to a 4 per cent rate from mid-1964 to the spring of 1965, and further to a 6 per cent rate from the spring of 1965 to the spring of 1966. This acceleration in monetary growth was very expansive.

In the third period, from early 1966 to late 1966, the rate of growth in total spending slowed somewhat. However, relative to the ability of the economy to produce as it approached capacity, total

^{1/} Data apply to the high-employment budget.

demand remained excessive. The upward climb in over-all prices rose from the 2 per cent rate in the previous period to a 3 per cent rate in this period.

Monetary restraint was an important factor in the slower growth in spending in late 1966. From April 1966 to January 1967, there was little change in the money supply -- a very restrictive monetary action compared with the 6 per cent increase in money in the previous 12 months.

By the fall of 1966 a restraint on spending was noticeable. Some spending units began to reduce outlays to conserve cash and revised their expectations downward. Credit demands tapered off. Interest rates, after reaching a peak in the early fall, declined until early 1967. Lower rates gave an impression of an easier monetary situation despite continued slow growth in the money stock. Final purchases by the private sector (gross national product less Federal Government outlays and net purchases of inventories) slowed to a 4.4 per cent rate from the first to third quarters of 1966 and further to a 2.6 per cent growth rate in the final quarter of 1966. In comparison, such purchases grew at about a 10 per cent rate from late 1964 to early 1966.

The marked slowing in the growth of final spending by consumers and businesses during 1966 was partially offset by accelerations in

Government spending and by some, apparently undesired, increases in business inventories.

Despite the pause in economic growth in late 1966, inflationary pressures remained strong. Over-all prices increased at a 2.3 per cent annual rate in the first half of 1967, following the 3 per cent rate of increase in the previous three quarters. Much of the slowing in price increases reflected a changed supply situation in agricultural products, bringing about a decline in quotations for farm products, processed foods, and feeds.

In the fourth period, late 1966 to date, activity first declined somewhat and then accelerated sharply. Of the two major tools of the Government for influencing the pace of economic activity, one was a stimulative force and the other was a restraining force in early 1967. Fiscal actions provided a strong upward thrust to spending; in fact, spending by Government (Federal, state and local) accounted for the entire increase in total spending in the first half of 1967. These outlays, through the "multiplier," probably had a stimulative effect on consumer and business expenditures. The lack of growth in money from the spring of 1966 to early 1967 had a dampening effect on private spending.

Sometime during the late spring of 1967 another marked and sustained change occurred in the pace of economic activity. Total spending rose at an estimated 9 per cent annual rate in the last half of 1967 after going up at a 3.4 per cent pace in the first half. Real

output of goods and services, which had changed little on balance early in the year, expanded at an estimated 5 per cent annual rate in the last half despite several major strikes.

This change from economic pause to rapid growth can be attributed to both fiscal and monetary developments. Each was very stimulative in the summer and fall of 1967. The sharpest change, however, was in monetary factors. The money supply rose at the rate of 7 per cent after having remained unchanged during the previous period. Fiscal actions, which were already the most stimulative since World War II, may have become slightly more expansive.

Summarizing developments since 1961, the combination of fiscal and monetary policies provided balanced and steady economic expansion until the end of 1964. In late 1964 these policies became more expansive, and by early 1966 demand for goods and services became excessive, and noticeable price increases occurred. Monetary restraint beginning in early 1966 began to slow expansion late in the year, and by early 1967 activity was showing virtually no growth. Despite the pause, however, inflationary pressures remained strong in the first half of 1967. By late spring, economic activity had turned up again as a result of stimulative fiscal and monetary policies. The upswing continued through the year with substantial price inflation during the last three quarters.

As a result of this excessive demand and price inflation, the Federal Reserve System has taken two steps which generally point to less expansive monetary conditions. Last November the System raised the discount rate from 4 to 4-1/2 per cent on eligible paper of member banks. More recently reserve requirements of the larger member banks were increased.

It is perhaps because of these moves and the upward trend of interest rates in recent years that I have been assigned the topic entitled, "The Economic Squeeze." I shall comment on it by addressing myself to the question of what would likely happen if less expansive fiscal and monetary policies are adopted. In answer, I suggest that total demand for goods and services would decline from the current excessive levels after a brief time lag. This would reduce pressure on the capital markets and tend to lower interest rates. But a more immediate impact on rates would probably occur as a result of reduced government borrowing and more stable price expectations.

Government deficits necessitate borrowing, and such demands for savings have the same upward pressure on interest rates as a similar amount of borrowing in the private sector. Less Government spending or higher taxes would reduce the deficits, thereby reducing needs for credit and the accompanying upward pressure on interest rates.

The effect of price expectations on interest rates is often overlooked. Nevertheless, it is quite real. Savers must protect the purchasing power of funds lent, and borrowers are willing to pay higher rates if they expect to repay in cheaper dollars. For example, if savings through the investment route yield a real rate of return of 4 per cent and prices are rising 3 per cent per year, savers would require a stated rate of 7 per cent to realize the 4 per cent real return on their savings. In this case, if savers have an opportunity to invest in capital goods where real rates of 4 per cent are still obtainable, savings institutions must pay a comparable rate to obtain loanable funds. Borrowers are as willing to pay the 7 per cent when they expect prices to rise at a 3 per cent rate as they are to pay 4 per cent under stable price expectations. It is this upward pressure on nominal rates necessary for a constant real rate of return that has pushed the nominal rates up to such high levels during the past two years.

What will happen with a less expansive monetary policy? In answer I shall comment again on 1966 developments when these policies prevailed. You will recall that interest rates rose for about 3 or 4 months after the stock of money stopped growing. Demand for goods and services, however, soon began to moderate and a reduction in rates followed. The more restrictive actions occurred in the second quarter of 1966, and by late September interest rates began to decline.

From these comments you can conclude that I am not impressed with fears of higher rates or a money crisis resulting from less expansive monetary operations. To the contrary, I suggest that the expansive monetary and fiscal policies of recent years have been the important factors that pushed interest rates up. A somewhat less expansive monetary policy than prevailed through most of 1967 would likely result in less demand for goods and services, more stable prices and, after a short time, lower interest rates.

While on this topic of interest rates, I would also like to point out that most of the so-called "money crisis" or "credit crunch" in 1966 reflected legal impediments to proper market functions. Many states have excessively restrictive laws with respect to interest rates. Such laws which limit rates paid and charged by savings institutions, i. e., commercial banks, savings and loan associations, etc., may do great damage to local communities.

When the supply and demand situation with respect to loanable funds calls for high interest rates, savings institutions must both pay and charge the higher rates or savings will find other outlets where the real rate of return is greater. Savings firms operating in such areas thus fail to grow at the same rate as such firms in freer market areas. These slower growing firms thus do not get the funds

to lend and credit becomes unavailable to their customers. It thus appears to me that most state restrictions on rates bear heaviest on those institutions and borrowers whom the restrictions are designed to help. Conversely, they aid the Federal Government, large businesses, and others that can successfully tap the central money and capital markets where rates are free to move with basic supply and demand conditions. The young borrowers, the innovators, and the fast-growing firms that would be willing to pay some premium for risk are excluded from credit markets in these communities.

Now a brief comment on your own field of activity, the retail farm equipment industry, and its relation to public economic policies. As indicated earlier, any combination of less expansive monetary and fiscal policies is likely to lead to lower interest rates after a short time lag. With the lower rates and greater availability of loanable funds, purchases of credit-financed farm equipment should be enhanced.

On the other hand, a continuation of the expansive public policies of 1967 would likely lead to further inflation. Rising prices combined with excessive demand for loanable funds for capital goods would continue to cause higher interest rates. With current limitations on interest rates in many areas, savings would tend to bypass savings

institutions. The result could be a slower rate of growth in savings institutions which lend to farmers. Some of the bypassing funds, however, might find a way into the farm credit field through merchants and dealers where rigorous rate ceilings are absent.

Ultimately, loanable funds like other productive resources move to lines of production where returns are greatest. If returns to capital invested in farm machinery can compete with returns to other types of capital in the economy, I see no reason why farm machinery will not get its share of credit regardless of the public policies which may prevail.

Speaking of returns to capital in agriculture, I shall briefly comment on another recent headline which may have some impact on American agriculture, namely, the devaluation of the British pound.

The devaluation of the British pound in November served to theoretically lower prices on British imports to the United States by 14.3 per cent and raise prices on our exports to Britain by about the same amount. Devaluation, therefore, had a favorable effect on British balance of trade and an unfavorable effect on the trade of countries which did not devalue.

The United States imports such items as scotch whiskey, bicycles, and other manufactured goods from Britain. The price reduction on these items, which was expected when the devaluation was announced, did not materialize, since British distributors

generally took higher mark-ups. Thus, the devaluation will have its greatest effect in higher returns to British producers and perhaps more advertising rather than more favorable prices for British products.

From the standpoint of U. S. exports to Britain, however, the devaluation may have greater impact. In 1966 the United States exported about one-half billion dollars in farm products to Britain, chiefly corn, wheat, tobacco, cotton, and meats. The price of these products imported from the U. S. is now higher in Britain than previously, so somewhat reduced imports from the United States are expected. In addition, several smaller nations such as New Zealand and Denmark, which also supply agricultural products to Britain, have devalued. Thus, the relative price of agricultural products from these countries has remained about unchanged, while the price of U. S. products was raised, placing our products at a competitive disadvantage. Exports of United States' farm products have increased in most recent years. Since 1955 farm commodity exports for dollars (outside specified government programs) have increased from \$2.3 billion to \$5.2 billion. Thus, a normal rate of growth in such exports in 1968 may more than offset any reduction as a result of the British devaluation.

In summation, the U. S. economy was expanding at unsustainable levels during much of the past three years. Resources approached

maximum utilization. Price inflation developed. Rising interest rates gave the appearance of restrictive monetary policies during much of the period. To the contrary, however, monetary policies were highly expansive. Restrictive monetary policies prevailed only during the last three quarters of 1966 and a few weeks in early 1967.

In response to recent economic developments, the Federal Reserve has raised the discount rate and increased reserve requirements, pointing to less expansive monetary policies. I suggest that less expansive monetary policies will lead to a decline in total demand and lower interest rates after a short time lag. The path to lower demand would be smoother with a corresponding restraint in fiscal policies, that is, a combination of Federal spending and taxes which will reduce the deficit.

I question whether any foreseeable combination of monetary and fiscal policies will have much impact on farm machinery sales. It appears to me that the financial institutions serving agriculture can obtain their share of loanable funds under most conditions that may develop. If less expansive monetary policies have an impact, it is likely to be in the form of lower interest rates to farmers after a short time lag. Such lower rates would tend to increase credit flows through the established savings institutions and provide more efficient credit sources to farmers.