OUR ECONOMY

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at the
Fourth Annual Marketing Theory in Action Conference
Chase-Park Plaza, St. Louis, Missouri
Friday, February 19, 1965

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Introduction

I know - - for I have been told - - that I am appearing before a sophisticated audience of university and graduate students with a mixture of businessmen. This precludes the opportunity for me to discuss the organization and administration of the Federal Reserve System, so I will refer to it only briefly in order to set the stage.

The Federal Reserve System is a typically American institution. In its organization it is a unique blending of the public and private sectors, and, like a democratic institution, in the performance of its responsibilities there are built-in checks and balances. The primary purpose of the Federal Reserve is to contribute to sustainable growth in our economy, with high levels of employment and reasonable price stability, and with a workable balance in international payments. This the Federal Reserve attempts to do by increasing or decreasing the funds available for spending.

To act with discretion - that is, to act to influence things - requires (1) that we have an informed judgment as to the current state of our econony, (2) that we have an informed judgment as to how our economy ought to be, and (3) that we have a pretty well thought-out idea of how to get from where we are to where we want to be. This involves theory in action.

So what I have to say in the next 20 minutes or so is similar to what we in the Federal Reserve System are doing every day. The impressions and judgments which I shall relate are not the result of a massive study pointed at today, February 19. Rather, today, February 19, I propose simply to interrupt a continually evolving process and report to you the present state of my thinking about our economy.

1964 Was a Successful Year

My first point is that 196 was a tremendously successful year: economic activity was at a high level, and has continued to rise into 1965; 1964 was the fourth year of continuous expansion; it was the 19th year of general postwar prosperity.

It isn't necessary to regale you with a host of statistics about last year to prove the point. However, I would like to mention several factors which epitomize the performance of the economy.

Total expenditures, or gross national product, rose at a 5. 9 per cent rate from late 1963 to late 1964, about the same as the rate of increase since 1956.

Industrial production, which accounts for about one-third of the nation's production activity, increased 8 per cent in 1964 compared with a 4 per cent average annual rate of increase since 1956..

A healthy aspect of our production picture in 1964 was that relatively little went into inventories. They are now about one and one-half times a month's sales; this is low compared with the situation we usually have at such an advanced stage of business expansion. This situation, wherein we do not have large inventories hanging over the market, is one of the factors which augurs well for the immediate economic future.

Along with the increase of production, we have had a substantial increase of employment. Total employment in late 1964 was 2. 4 per cent higher than a year earlier. This showed strength in the demand for labor, since the number of persons aged 20-64 is estimated to have increased only about half that rapidly (1.1 per cent).

I am increasingly uncertain as to what the unemployment figures mean. But, for whatever it is worth, the much-advertised unemployment rate, not adjusted for seasonal influences, was 4.7 per cent at the end of 1964 compared with 5.3 per cent a year earlier. The unemployment rate for those seeking full-time work was 3.7 per cent, and for those seeking full-time work who have been unemployed five weeks or more the rate was 2.0 per cent.

At the same time that we have had this excellent production and employment experience, price trends have not changed. This would seem to indicate that total demand has not been excessive; i.e., that fiscal and monetary policy have not been too stimulative. The general wholesale price index has been about unchanged since 1958. Other price indexes have moved up, but there is some question whether they take adequate account of quality improvements.

Causes of Economic Successes of 1964

Let me now turn briefly to some of the causes of the economic successes of 1964. Here is where "theory in action" enters the picture.

But first, a slight digression. I have often heard the idea that there is, on the one hand, such a thing as "theory" and, on the other hand, such a thing as "practice." In my experience with the formulation of monetary policy I have been greatly impressed by the fact that "theory" and "practice" (or "action") are not unrelated - indeed, they are inseparable.

In order to identify the "causes" of the economic successes of 1964 it is necessary to appeal to theory in action. Also, in order to make judgments about what is likely to happen in the near-term future, it is necessary to draw upon our ideas about theory. This is especially the case in policy-formulation. In the context of policy, it is necessary to relate (in theory) the specific actions that the Federal Reserve System can take - reserve requirement changes, discount rate changes, and open market operations - in relation to the myriads of happenings in the economy - both domestic and international.

An evaluation of the causes of successes in 1964 must begin with the recognition of the role of private enterprise - the willingness of business and industry to invest, to build, to expand and produce. There is no substitute for profit motive. An evaluation of the causes of success in our economy must also give due recognition to those who anticipate wants and needs and who stimulate desires to purchase. Marketing people represent a key link between the raw act of production and final sale to the consumer; enterprising people, who are basically interested in fulfilling their own private destinies, make the underlying decisions which mold the character of the economy.

To a large extent, the job of monetary policy is simply that of providing a stable monetary environment within which the private economy can flourish. In 1964 the money supply increased about 4 per cent, continuing the rate of the year before. This is about twice as fast as for the past 10 years as a whole.

Consistently with the increase of money supply, interest rates changed little during the year. Usually during economic expansion interest rates rise. The Federal Reserve, by facilitating the increase of bank reserves, bank credit, and money supply, helped to keep interest rates down and to keep the economy expanding.

Finally, and in terms of government policies perhaps the most important, we must consider the tax cut. If we had not had the tax cut it is unlikely that we could now be enjoying the degree of prosperity we are currently having.

In short, judged by employment, production, growth, and price level developments last year, policy actions appear to have been appropriate. The Federal budget situation which emerged from the tax cut, the rate of increase of money which prevailed before and during 1964 had stimulative effects on the economy but do not appear to have been inordinately expansive.

Future Prospects

With respect to the future, one may hear almost every possible view. It is said that the dollar will be devalued and that there will be price inflation. At the other extreme, it is said that it is a very old tired expansion, that housing starts are down, and that recession will come before the year's end. As for devaluation, it is surprising that this matter keeps cropping up. The United States government has taken a consistent stand on this for more than thirty years. In any event, doubts should have been put to rest by the recent statement by President Johnson that "the dollar is, and will remain, as good as gold, freely convertible at $35 an ounce."

This point about the recovery being 4 years old of itself seems to me to have little significance. You remember that when the recovery was 2 years old it was thought remarkable; when it reached 3 years it was astonishing; what word shall we use now that we are entering the 5th year? Is it unbelievable? Not necessarily. Here again enters theory in action. The conditions which make for recession may or may not be present. Whether we have inflation or recession, or go ahead in a sound manner, depends in large measure on whether the private enterprise economy continues to find outlets for profitable venture, and on whether we follow sound monetary and fiscal policy.

Policies, in turn, must be attuned to the problems facing the country. I have discussed the successes of 1964. I would like to spend the final few minutes of my time discussing the darkest cloud now on the economic horizon - our international payments deficit.

Balance of Payments

The deficit in 1964 is reported to have been $3 billion. For the fourth quarter it was at an exceptionally high rate, roughly $5.8 billion; this rate is higher than the $2.0 billion rate over the first three quarters of the year, and was the highest quarterly rate in the last several years.

The rise in the deficit was mainly due to the resumption of foreign security issues in our capital markets and to an outflow of short-term funds in the form of loans by banks, corporations, and others. Other factors of less significance were involved but time does not permit an itemization of each. The point is - - the deficit has continued for several years and at higher rates than are desirable. It is essential that we meet the problem.

As you know, a broad program aimed at restoring a reasonable balance in our international accounts was launched last week by President Johnson in a special message to Congress. While I much prefer general controls to direct specific controls, the situation now calls for concessions and the Federal Reserve System is in complete sympathy with the proposed program.

Basically there are four areas that require attention:

(1) Try to improve the trade balance.

We enjoy a favorable balance-of-trade. In the fourth quarter our exports of goods and services exceeded our imports by $6.9 billion. While the balance in our favor was on the average greater in 1964 than in 1963 or 1962, there was a gradual erosion after the first quarter. Efforts to expand our exports need to be increased. This calls for new thinking, new planning, and new marketing on the part of business and industry.

(2) Government Programs

(a) Aid.

When a dollar of foreign aid is spent in this country, the outflow of aid is matched by an export. The real effect of this sort of aid is that we lose the goods and services. If the aid money is not spent in this country, it may later show up in the form of a claim against our gold; this we are trying to avoid by tying aid to purchases here. It is estimated that about 80 to 86 per cent of all aid is tied. I am hopeful that further improvements can be made in this area.

(b) Military expenditures abroad.

These amount to nearly $3 billion, and consist largely of payments to U. S. Personnel abroad and supporting expenditures. The President has stated that, consistent with national defense needs, we will seek to further reduce these outflows. We can do this by possible reduction of forces abroad, and by encouraging offsetting purchases of U. S. military equipment by friendly foreign countries.

(3) Travel

U. S. residents spent about $3.0 billion on "tourism" abroad, more than twice what foreigners spend in this country. A reduction in this would, of course, work in the right direction. It is hoped that the legislation to reduce duty-free allowances to $50 will be helpful.

(4) Capital Outflows

The central focus of the President's program is on measures to reduce financial outflows. These outflows have been heavy in recent years and in recent months have contributed to a worsening of our payments position. In the 4th quarter of 1964, for example, bank credit to foreigners expanded by $1 billion. At this time, therefore, our chief concern is with capital outflows - - short-term, long-term, and direct.

The President's message of last week contained proposals to do the job. He invoked the Gore Amendment, extending the Interest Equalization Tax - - whose application had been limited to investments in securities - - to bank loans of more than one year. He also proposed that American business join with the Federal government in a voluntary credit restraint cooperative program to help protect the dollar.

Concluding Remarks

At the outset I mentioned that the Federal Reserve System has several goals: sustainable growth with high levels of employment, reasonably stable prices, and a workable balance in our international payments. These are our concerns, but at the moment the payments problem is of vital concern.

As I have noted, we have had 19 years of economic expansion in the United States and, more recently, 48 months of continuous economic growth. This is a good record and one in which we can all take pride. Some have said we may be riding for a fall. In my judgment, this is not necessarily so. But we must have the determination and courage to tighten our belts when necessary to prevent imbalances and to protect the value of the dollar.

When I say we, I certainly include those of us who have responsibilities for formulating monetary and fiscal policy. But equally and perhaps more important, it includes labor, business, industry - the general public. In other words, it includes you and me, because in a democracy policy to be successful must receive the support of the people. I believe we have what it takes.