Some Economic Problems of 1967 *

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As we emerge from the difficult year of 1966 and face the uncertainties of the new year, it is not too much to hope that the stresses and strains will be less severe, and the problems less perplexing, than in the year we have just lived through. I shall not burden you with anything more than a brief and therefore oversimplified reference to last year's difficulties in the areas in which you as bankers, and I as a central banker, are especially interested.

The balanced business expansion of 1961-64 gave way in mid- or late 1965 to an overheated economy, mainly because a greatly expanded war effort in Vietnam was superimposed on a peacetime economy marked by growing capital expenditures and nearly full utilization of labor resources and plant capacity. As a result, prices and costs came under increasing pressure, bringing to an end the fine price-cost record of the early 1960's. In a situation in which a combination of fiscal restraint and monetary restraint was clearly needed, monetary policy had to carry the major share of the burden of counteracting the inevitable inflationary pressures that followed from these circumstances. As many of us in the Federal Reserve System have often pointed out, the penalty of having monetary policy carry this heavy burden is usually the development of almost unbearable strains in financial markets, with excessive increases in interest rates—and last year's experience amply proved the point.

Much has changed, of course, since last summer. Above all, the domestic economy has cooled off perceptibly; and, while credit demand has remained high, it has been less insistent than in earlier months, market rates have declined sharply, and market expectations have undergone a fundamental change. Last month's termination of the Federal Reserve statement of September 1, 1966 on business loans and on discount administration was widely regarded as evidence of a significantly less restrictive System attitude. The President's proposal for a 6 per cent surcharge on taxes appears to me to be a constructive move toward providing a better mix of fiscal and monetary policies to meet the new conditions we will face this year. The relation of these policies to the unfolding economic and financial scene will undoubtedly be a matter of continuing importance and interest to all of us in 1967.

While 1967 is bound to be different from 1966, I think it would be unwise to assume that we can relax and expect that the nicely balanced and vigorous expansion of the early 1960's will be automatically restored. In fact, as we enter 1967, I am impressed by the seriousness of some of our unsolved economic problems. Perhaps this is a good time to take stock of our position and, without attempting a forecast, to suggest where some of these problems are most likely to develop as we seek to achieve our basic economic goals. Those goals, as you know, are maximum sustainable economic growth, high employment of resources, substantial price stability, and near-equilibrium in our international payments.

Doubts as to whether we shall see an adequate rate of economic growth seem to be a major source of public concern at present. There is a good deal of talk among economists, both in and outside the Government, about the possibility that we are on the verge of a recession. They cite such items as the probably much slower gain in business outlays on plant and equipment in 1967 than in 1966, with a dim profit outlook as a strong causal factor; the probability of an inventory correction following the recent tendency for inventories to accumulate at an excessive pace; and the prospect of somewhat lower automobile sales, on top of already sharply depressed housing construction.

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It would, of course, be foolish to dismiss out of hand the possibility of recession. Nevertheless, I find the case for recession decidedly unconvincing. Our Bank endeavors to keep in close touch with a representative cross section of businessmen, and most of them look for considerable sales gains in 1967, though profit prospects are much less certain. And even the most pessimistic forecasts seem to envision a sizable growth in GNP in the current year. Above all, it is hard for me to conceive of a recession developing in the face of the advance in Federal defense expenditures that seems probable in the light of Vietnam. Admittedly, this is an area full of uncertainties—but the probabilities seem to favor continued significant expansion of Federal spending. Also, outlays of state and local governments are likely to increase by an amount no less expansive than last year's record gain.

Perhaps the argument about the danger of "recession" is more a matter of semantics than of substance. I have a feeling that many of those who use the term are thinking more of a drop in the rate of growth of the economy than of an actual contraction. Of course the economy's rate of growth has slowed. It was quite natural to expect such a slowdown as the slack of unused resources in our economy was absorbed; and, indeed, it was necessary to encourage the slowdown through official policy in order to prevent a disorderly scramble for scarce resources and even greater price increases than actually occurred.

In periods of high employment, such as 1966, real growth potential is closely dependent upon net additions to the labor force as determined by population trends. Moreover, in such periods productivity gains also tend to slow down—as clearly occurred in the past year—further reducing the economy's potential for real growth. In this setting, it seems reasonable that our goal with respect to growth should be more modest in the next year or two than in the early 1960's. Perhaps a real growth rate of around 4 per cent would be a reasonable objective under current circumstances, although it might be necessary to accept temporarily a slightly slower growth rate as a means of achieving a satisfactory degree of price stability. In any case, I see no reason why a growth rate of this general magnitude should be a prelude to genuine recession. On the contrary, at this stage an orderly stepping-down to a sustainable growth rate is much less likely to lead to recession than would a resumption of excessively rapid and unbalanced growth.

It would, of course, be desirable not just to avoid a recession but to bring about a further decline in unemployment. But, it is pretty generally recognized that further substantial reduction of unemployment is a longer run matter, and must depend primarily on the gradual effects of structural improvements which may result from programs to improve training, labor mobility, and general standards of education and health. There are still severe shortages of many types of skilled labor, so that any effort to reduce unemployment further merely by stimulating aggregate demand would probably do much more harm than good.

One of the disturbing aspects of the present economic debate is the apparent willingness of too many people to accept considerable cost and price increases as inevitable in the coming year. To some extent, of course, excessive demand always has lagged effects on prices and costs, and we are seeing such effects now even after the cooling of the economy which I have mentioned. For one thing, the wage structure is under mounting pressure as a consequence of earlier increases in the cost of living. If the large number of major wage negotiations scheduled for 1967 tend to follow or exceed the recent 5 per cent pattern, they will be far in excess of any likely national productivity gains and will therefore add to inflationary pressures. The tendency toward cost-of-living escalator clauses is likewise disturbing.

It is one thing to say "some degree of inflation is inevitable but let us try to limit its extent", and it is quite another thing to say "inflation will happen anyway and we can do nothing about it". Both private and public policies can be of great value in restraining the degree of upward cost and price pressures, and appropriate policies—not only in the monetary and fiscal area, but also in the wage and price decisions of labor and management—are likely to be sorely needed this year. To put it in another way, in my judgment, the risk of inflation over, say, the next twelve months, still outweighs the risk of recession by a substantial margin. And, as I have pointed out on other occasions, ground lost to inflation is usually lost permanently.

So far I have said very little about developments in the area of credit and financial markets. There appears to have been a net decline in bank credit in the three-month period of September through November, at least if our seasonal adjustment factors did not go badly astray. This was certainly more than we had looked forward to. To some extent, this sharp reversal was perhaps a natural counterpart of excessive fears and consequent overborrowing in the earlier months of the year and of the speedup of corporate tax payments in the second quarter. But it also reflected a greater reluctance of banks to lend in the light of the significant reduction in bank liquidity. In any event, it is gratifying to note that the figures for December and early January point to a resumption of bank credit expansion.

So far, most of the curtailment in credit expansion during the fall months seems to have been due more to necessitous rationing by the lenders than to any weakness in credit demand. I have the impression that bankers continue to look for rather strong loan demand in the coming months. In many instances, however, their liquidity position will probably induce continued caution in the rate of expansion of their lending operations. On the other hand, the decline in market rates over the past couple of months has placed the banks in a greatly improved position with respect to retention or expansion of time deposits. Other savings institutions have also experienced a vast improvement in their flow of funds. Demands in the capital market from both corporate and municipal borrowers remain heavy, and while passage of the President's new tax proposals will limit the demands of the Federal Government, these will still be substantial. While I shall not be so rash as to attempt any forecast of interest rates, I think it is well to bear in mind that rates are the result of many varied forces operating on both the demand and the supply side of the market.

No review of the problems we face can neglect our balance of payments and our international position generally—an area which is a matter of deep concern. In any review of the past year's experience, it is obvious that Vietnam has been an important adverse factor. Without trying to set a figure on this influence, I would point out that in addition to the direct military outlays abroad there are a variety of indirect effects, including of course those reflecting the overheated condition of our domestic economy in 1966. After so many years of continuous deficit and so many high-level assurances to the world that our payments would be brought into balance, I think it essential that this goal receive urgent attention from all elements in this country, private and public, which are capable of contributing to a remedy.

Unfortunately, achievement of balance in our external accounts will be anything but easy. Our biggest hope lies in the expansion of the trade surplus. Perhaps we can reasonably look for an improvement on the import side, provided that the expansion of the domestic economy does not become excessive, but we should not overlook the fact that some of the foreign countries that are our major export customers are also tending to grow at a more moderate pace, and this may have implications for our export prospects. In general, I think it is fair to say that our world competitive position has been well sustained, but must be made even stronger. The cost and price pressures currently in prospect must, therefore, be strongly combated if we are to avoid undermining our international trade position.

Turning to international capital flows, we find a variety of crosscurrents, but on balance we benefited greatly in 1966 from tight credit conditions in this country and the resulting high interest rates. We can hardly hope for benefits of similar magnitude in 1967. Indeed, whereas the inflow of private foreign short-term funds brought a small surplus in our official settlements account last year, we shall be lucky this year if some reflux of these funds does not develop. In general, even the slackening of credit pressures and the decline in interest rates which we have seen already in the United States may have appreciable adverse effects on net capital flows, unless there is an equivalent reduction of credit pressures and interest rates in major foreign countries. To some extent such a parallel reduction of credit pressures has occurred so far, but it cannot necessarily be counted on. Under these circumstances, I think it was inevitable and highly desirable that the voluntary credit restraint program should be continued and indeed modestly strengthened for the year 1967. Regardless of this program, however, excessively easy domestic credit conditions could have a disturbing effect on our balance of payments.

I am quite aware that artificial restraints on international capital flows are in principle undesirable. But, as I view the alternatives, artificial restraints are a lesser evil, required for the time being to prevent a greater evil in the form of weakening of confidence in the dollar. Certainly measures of this kind are not suitable permanent components of a desirable system of international financial payments. Thus, it behooves us, and all the other major industrial nations, to continue our efforts to achieve means of adjustment that are of an expansive rather than of a contractive nature. For the United States this means, above all, continued emphasis on the achievement of a larger current account surplus.

Naturally, it is hard for our industrialists to accept any restriction on their freedom to invest wherever in the world they see interesting profit possibilities. We often hear expressed the view that any interference with direct American investment abroad (i.e., investment in plant and equipment or working capital of subsidiaries or branches) must be wrong, in view of the splendid returns earned consistently on the aggregate of such investments in recent years. It is also true that the United States, because of the sheer size of its economy and of its national savings, and the high efficiency of its financial institutions, should be a natural supplier of capital to the rest of the world, especially the less developed countries.

As for the attitude of the recipient countries toward inflows of American capital, it is impossible to generalize. In some countries the desire to obtain the most up-to-date American machinery and technical methods runs head on into the familiar argument that too much of the country's industry is falling under American domination. Reluctance of some countries to accept American investment has been tempered by the realization that, if obstacles are created, the American concern in question will probably carry out the same plans in a neighboring country. Thus, the first country may ultimately feel all the competitive effects of the new plant's establishment without receiving any benefits that accrue from having the plant located on its own soil. I should not overlook the feeling of many large American corporations that expansion abroad is an absolute must if the corporation is to retain an adequate degree of dynamism and can also be of great benefit in helping to sustain exports from American plants. Just to complete this picture of confusion, I might mention also the attitude of some of the foreign Finance Ministers and central bankers who may regard such American investment, at the time it is made, as an unwanted source of additional foreign exchange and an unwanted contributor to inflationary pressures in the economy of their country.

Having sketched the problem, I suppose I should have some solution to offer. Unfortunately, however, I do not think there are any easy solutions. Perhaps the relationship between a free flow of American investment abroad and the reserve policies of foreign monetary authorities deserves further study. More broadly, it seems to me that possibly the most challenging problem which this country faces in the sphere of international economics is how to reconcile equilibrium in our balance of payments with the fulfillment of our vitally important role as a supplier of capital, both private and Government, to other parts of the world.

Perhaps I have said enough to indicate that 1967 is not likely to be an easy year for policy makers or for anybody else. Quite to the contrary. The task to be faced by monetary policy will hinge not only on the pace of the economy, on cost-price pressures, and on international payments developments, but also on the role of the Federal budget in adding to our burdens or helping to alleviate them. It seems to me that on balance a less stimulative Federal budget has been needed for some time, and I welcome the President's proposal for a temporary but general tax increase. While, currently, the need to restrain an overheated economy is somewhat less pressing than earlier, the size of the projected Federal deficit is such that an increase in revenues seems much in order. We could easily discover in the months ahead that the economic expansion was again accelerating. In view of the rather lengthy period that is usually needed to translate a proposal to raise taxes into actual legislation, I think it highly prudent to have a proposal already on the table and under active consideration. Admittedly, however, this is an area in which others have responsibility and special competence. The only reason I speak of it at all is because of the close relationship with our own activities and my fervent belief that monetary and fiscal policy must work together for the solutions of the nation's economic and financial problems. I am rather confident that, on the strength of the lessons learned in the past year, the nation will succeed in achieving a much more orderly progress in the coming year. But this will require the keenest vigilance on the part of all of us, and I am sure we would all agree that the goal is worthy of the effort.

And I know that, as I have sketched the problems our economy may face in the coming year, you have been thinking of how those problems—and our efforts to deal with them—will affect you and your institutions. Many of you faced great difficulties last year as insistent credit demands found you with inadequate funds to satisfy all your creditworthy and long-established customers. Moreover, you watched with some apprehension as your loan-deposit ratios rose and your liquidity dwindled. I would like to suggest that, if efforts to keep the economy fully employed and growing at something near its full potential are successful, you will continue to face similar problems. You will have to continue to make sound judgments when allocating the resources available to you. If you make those decisions in ways which promote the best long-term interests of your community and the nation, the problems ahead will be less difficult than they would be otherwise. In short, there is a job for all of us to tackle, and I solicit your cooperation.