GOVERNMENT(S) AND INFLATION

Remarks of

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of San Francisco

Meeting with Sacramento
Community Leaders and Directors,
San Francisco and Los Angeles Offices,
Federal Reserve Bank of San Francisco

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The biting of bullets will be the major occupation of fiscal planners this year — in Washington, Sacramento, and other seats of government — according to Mr. Balles. In the last analysis, the fiscal crisis in every governmental jurisdiction can only be overcome through a balanced fiscal and monetary attack on inflation. Federal Reserve policy is based on a simple premise — the inflation process cannot persist very long without monetary accommodation. But the Fed's policy can be successful, without massive financial-market distortions, only if government policymakers reduce their credit demands.

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I'm grateful for the opportunity to visit this one-major-industry town, and to bring you up-to-date on developments in that other one-major-industry town on the banks of the Potomac. Life is hard in both places these days, because the political leaders of the 1980's must deal with the results of all the economic and political mistakes made in the 1960's and 1970's. In my remarks today, I'd like to comment on how we got into our present difficult state — the answer is, primarily through inflationary policies — and how we can get back on a non-inflationary growth path.

First let me pause to discuss another purpose of this meeting, which is to give the leaders of this community a chance to get together with the directors of our San Francisco and Los Angeles offices. Our directors are an able and diverse group of individuals, and they help in many important ways to improve the performance of the Federal Reserve System, the nation's central bank.

Role of Directors

The directors at our five offices are involved with each of the major tasks delegated by Congress to the Federal Reserve. That encompasses the provision of "wholesale" banking services such as coin, currency and check processing; supervision and regulation of a large share of the nation's banking system; administration of consumer-protection laws; and in particular, the development of monetary policy. We are fortunate in the advice we get from them in each of these areas.

Our directors constantly help us improve the level of central-banking services, in the most cost-effective manner. This is a crucial role at the present time, because under the terms of the new Monetary Control Act, the Federal Reserve is

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moving into a new operating environment. Over the next year, the Fed's services will become available to all depository institutions offering transaction (check-type) accounts and nonpersonal time deposits, and those services will be priced explicitly for the first time.

Yet above all, our directors help us improve the workings of monetary policy. As one means of doing so, they provide us with practical first-hand inputs on key developments in the various regions and industries of our nine-state district. Our directors thus help us anticipate changing trends in the economy, by providing insights into consumer and business behavior which serve as checks against our own analyses of statistical data.

Outlook for California

Our directors' comments, along with our staff's analyses, give us a rather firm picture of what to expect in the California economy in the year ahead. The overall picture is of an economy which continues to outpace the national economy, even though beset by many of the same problems which are troubling the nation as a whole. On balance, this would suggest a 2-percent increase in California employment this year, to 10.6 million, along with a 12-percent rise in personal income, to somewhere around $290 billion.

Much of the growth, in 1981 and in the 1980's as a whole, can be traced to the demand pressures created by strong population growth. California's population reached 23.7 million in the 1980 Census year, with a 1.7-percent average annual growth over the preceding decade — double the national rate, although somewhat below the historic California rate. Almost 400,000 births took place last year — the largest in the state's history — despite the continued reluctance of

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California families to have more children. This suggests an upsurge in demand for elementary schools and day-care facilities a few years hence. But migration accounted for fully half of the 3.7-million population gain of the 1970's, and it should continue high this year and for years to come. Our market and labor-force planners must continue to take account of this constant inflow of refugees — including those fleeing from war in Southeast Asia or from the poverty and turmoil of Latin America, or simply those fleeing from the declining industries and the energy-poor communities of the American Snowbelt.

Some analysts like to say that California's economy parallels the nation's, plus or minus aerospace. When that key industry is weak, as it was a decade ago, California lags somewhat behind the national growth pace. But when defense contracts flow into that industry, as has been happening recently, California spurts ahead of the rest of the nation. Since this state receives roughly one-fifth of all Pentagon contracts, it stands to benefit from the Administration's budget expansion in that field. According to the White House proposal, the total defense budget should rise at least 14 percent, in real terms, both this year and next — and California should feel the impact because of the budget's heavy emphasis on strategic weapons, such as a new manned bomber.

The prospects for other major industries appear somewhat mixed, as is true of their national counterparts. Gross receipts of the state's farmers and ranchers could rise about 15 percent this year, to $16 billion, but their net income may rise only modestly over last year's depressed level because of the continued upsurge in production expenses. Overseas markets, which normally take about one-fifth of California's farm products, may be less of a factor this year because of the

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sluggish nature of business activity overseas, and because of the rising prices of U.S. products as a result of the weakening of many currencies against the dollar. The state's tourist industry meanwhile may remain hampered by the rising cost of air travel, lodging, food and entertainment. And California's consumers, like their counterparts elsewhere, may continue to postpone their purchases of big-ticket items until purchase prices and financing costs come down out of the stratosphere.

The most important of the credit-sensitive industries, housing, deserves special mention. Despite all of the industry's problems during the 1970's, the state's housing stock increased 32½ percent over the decade, considerably outpacing an 18½-percent population increase. Yet most industry analysts speak of a constant shortage of housing in the state, amounting to almost 100,000 units in this and each of the three preceding years. Certainly the cost of California housing suggests a heavy demand for the product, with the median-priced home approaching $100,000 and the average being much higher in major metropolitan areas. But the much lower price of housing elsewhere — with homes costing 10 to 20 percent less even in such growth areas as Phoenix and Houston — suggests the existence of land and other supply constraints on California's ability to house its growing population.

Outlook for the Nation

Still, I should emphasize that California — despite its vast size and diversity — will predominantly reflect several major national (and international) trends this year. Let's consider the situation confronting the national economy today. To improve its political and economic strength in an uncertain world, the U.S. has embarked on a drive to re-arm, to re-energize, and to re-industrialize,

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while struggling all the while to overcome the inflation that has caused so many of the nation's economic and financial ills. These initiatives are forcing us to make some difficult decisions, including steps to encourage shifts in consumer budgets from spending to saving, so that more dollars will flow into investment channels to build up the nation's strength. The transition period thus can be painful, as we've seen from the recent record of fluctuating growth and continuing inflation.

Business activity has followed a very bumpy path over the past two years. In the spring of 1979, consumers and business firms reacted to sharp increases in oil prices by cutting auto and truck purchases drastically, so that total output (GNP) actually dropped in real terms. Then, after three quarters of growth, a widespread decline in goods purchases last spring brought on the sharpest quarterly output reduction of the past generation — 10 percent, at an annual rate. Three more quarters of growth then followed, with real GNP accelerating after mid-1980 and reaching a rapid 6½-percent annual rate of growth in the first quarter of this year. But after all that backing and filling, real GNP is only two percent higher now than it was two years ago.

Near-term business prospects are somewhat hard to measure, as the economy tries to shift gears while being battered by the forces of inflation. Still, I'm inclined to say, after much hedging, that the consensus forecast for a relatively sluggish year is the most likely outcome. Without doubt, we can expect boom conditions in certain industries, such as energy, defense and office-building construction. Almost as certainly, we can expect at best a modest recovery in autos, housing and other consumer-related industries.

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On balance, this means that real output of goods and services will rise perhaps by one or two percentage points for the year as a whole, and that the proportion of jobless in the labor force will edge upward from the 7½-percent plateau where it has hovered ever since the spring of last year. Those jobless figures represent major pockets of unused resources throughout the economy — an especially serious problem for those who are unemployed — but they don't represent widespread weakness in the economy as a whole. Indeed, the proportion of the adult population with jobs, at 58½ percent, has been exceeded only at the peak of the 1978-79 boom. And the constant reduction in business inventories since mid-1980 suggests that the next major move will be upward as pipelines are refilled.

Problem of Inflation

Neither California nor the nation can expect a sustained recovery, however, until we achieve more progress in the fight against inflation. As measured by the consumer price index, inflation doubled within the single decade of the 1970's, and at the recent pace, would double again within only about a half-decade. The price indexes have given off mixed signals recently. Still, with the exclusion of volatile housing costs from the index, consumer prices have risen at an 11-percent annual rate over the past six months, compared with a 9½-percent rate of increase in the preceding six-month period. The picture isn't completely black; the latest monthly consumer report showed some deceleration, while some raw-material producers are offering goods at prices lower than a year ago. But on balance, we have strong reason to maintain a tight anti-inflation policy in the months ahead.

The danger is not just the continuation of external price "shocks" — of which we've had

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more than our share — but also the uptrend in the underlying (or non-shock) rate of inflation. American households are suffering from their second major oil-price shock, as evidenced by a two-thirds increase in the energy component of the consumer-price index over the past two years. Moreover, despite the current glut, most energy analysts expect a sharply rising trend of prices over the longer-term, with the gradual depletion of the world's low-cost oil reserves. Food prices meanwhile could rise substantially this year, although improved growing conditions recently have dissipated some of the earlier pessimism on that score. On balance, the food-price increase this year could match the 10-percent rise recorded over the past 12-month period.

Still, food and energy account for only about one-fourth of our household budget, and inflation has worsened in other sectors as well. Throughout most of the past decade, this underlying or core rate of inflation, although accelerating, remained below six percent a year. In the last several years, however, the underlying rate has exceeded nine percent. This upsurge in inflation has gone hand in hand with an upsurge in unit labor costs, because of sharp gains in labor compensation and actual declines in the productivity of the nation's workforce for three successive years, from 1978 through 1980. I should add that the recent (first quarter) productivity figures were quite heartening, but we still have lots of ground to make up on that score.

The cure for that type of cost-push problem is productivity-enhancing tax stimuli, such as those Congress is now considering. But the upsurge in inflation has also gone hand in hand with the excessive money growth of past years, which resulted when monetary policy was pushed off

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course by the excessive credit demands generated primarily by Federal deficit financing. The cure for that type of problem is to curb rapid money creation by reducing deficit-financing pressures.

Fed Policy and Its Critics

In an attempt to improve its control over money growth, the Federal Reserve changed its procedures in October 1979 — in effect, by placing more emphasis on controlling the quantity of bank reserves than on tightly pegging the cost of those reserves (that is, the Federal-funds rate). But the Fed was only partially successful in curbing money growth in 1980, in the face of sharp changes in inflation expectations and wide fluctuations in credit demands.

The most important money-supply measure, M-1B — currency plus transaction, or check-type, accounts — increased 6¾ percent in 1980 (4th quarter-4th quarter). By that measure, the rate of money growth has declined slightly for two years in a row. In fact, the 1980 figure was the smallest increase of the past four years. Still, it slightly exceeded the upper limit of the Fed's targeted growth range for the year of 4 to 6½ percent. Meanwhile, interest rates showed extreme fluctuations around a rising trend, with the prime business-loan rate falling as low as 11 percent at midyear and rising as high as 21½ percent at year-end.

Amid all this financial turmoil, the nation's central bank came under heavy attack, usually from two opposite sides of the issue. The controversy, increasing in volume during the past year or so, has centered around two conflicting views of monetary policy. To the average newspaper reader — and perhaps the average legislator — easy money means low interest rates, and tight

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money means high interest rates. To the average economics professor or financial analyst, easy money means high money growth, and tight money means slow money growth. Thus, in the early months of 1980, the Fed was criticized by the interest-rate watchers as being too tight, and criticized by the money-supply watchers for being too easy. In the second quarter, the criticisms were reversed; in the third quarter, they were reversed again — and so on into 1981.

Fed Response to Criticisms

The central banker's life is not an easy one in any case, but it becomes even more difficult when he's advised to follow two completely opposite policy courses at the same time. So how should we respond? To the interest-rate watchers, we would suggest that interest rates are determined by many factors — including but not exclusively the actions of the Federal Reserve, which can control only the supply of money, not the demand. Certainly the Fed has some influence over rates in the short run, as it works to control the amount of reserves in the banking system and money in the hands of the public. By restricting reserves and money, the Federal Reserve can temporarily raise interest rates — and by easing the supply of reserves and money, it can temporarily lower rates.

However, business-cycle conditions also influence rates, as credit demands rise and fall with the cycle. And above all, price expectations heavily influence rates, frequently offsetting other market influences. Today, for example, if people expect prices to rise by (say) 10 percent a year, lenders will demand the "real" underlying rate of interest plus 10 percent, so that they'll be protected against an expected loss in the purchasing power of their money. This suggests, then, that curbing inflation is the only long-run solution to high interest rates.

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To the money-supply watchers, we would say that monetary policy in recent years has been directed toward reducing money growth, especially since the October 1979 shift in Fed procedures. History shows that changes in money-supply growth definitely affect the inflation rate over time, generally with about a two-year lag. The Fed thus should continue to follow the path of gradual deceleration adopted several years ago.

We recognize of course that little has been achieved by the large swings in money growth experienced over the last year or so. Those swings could be dampened by the adoption of certain technical changes in policy implementation, such as the Fed is now considering. But variations in money growth probably cannot be completely eliminated, given the existence of major shifts in underlying economic conditions. (For example, the swing in real GNP of the middle quarters of last year was the sharpest such change in recent history.) Again, we have to recognize that the Fed's shift in emphasis away from trying to control interest rates can involve some short-term costs. Home builders, farmers, small businesses, and other interest-sensitive borrowers can be badly hurt by high and fluctuating levels of interest rates. The Fed thus must step in at times to dampen excessive rate swings, even at the cost of temporary rapid growth of the money supply.

On balance, the Federal Reserve has no choice except to continue with its policy of reducing money-supply growth over time, to help the national economy return to a non-inflationary growth path. Thus, the Fed has reduced its projected growth range for the M-1B monetary aggregate by a half-percentage-point in 1981, to between 3½ and 6 percent. (That calculation abstracts from the impact of shifts into NOW accounts and other interest-bearing transaction

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accounts.) The new target range thus implies a significant reduction in the monetary growth rate, in comparison with last year's 6¾-percent growth.

Against the background of the economy's strong inflationary momentum, the Fed's target is frankly designed to be restrictive — as Chairman Volcker (with strong Administration support) has emphasized in recent Congressional appearances. The target implies restraint on the potential growth of nominal GNP, which represents real growth plus inflation. If inflation continues unabated or increases, real activity is likely to be squeezed. But as inflation begins to abate, the stage will be set for stronger real growth. The Fed's policy is based on a simple premise — the inflation process cannot persist very long without monetary accommodation. However, the Fed's policy can be successful, without massive financial-market distortions, only if government policymakers reduce their credit demands.

Need for Balanced Anti-Inflation Program

As I've suggested, a balanced anti-inflation program would include measures to improve the nation's productivity and international competitive position, along with measures to reduce deficit-financing pressures on monetary policy. The President's new fiscal program represents an important step in the right direction. It includes personal-income tax cuts and accelerated depreciation write-offs designed to stimulate a long-awaited improvement in productivity-enhancing investment. The program also includes a broad and judicious mixture of spending cuts designed to keep deficits from spiralling and creating even worse pressures on financial markets. The proposed cuts range across a wide range of programs, from food stamps to synthetic-fuel development, from

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extended unemployment compensation to the space-shuttle program, and from public-service jobs to postal subsidies.

Still, the Administration's budget proposals result in large fiscal deficits for the next three years, with no balanced budget in sight until 1984. For fiscal 1981, which is now half over, a $55-billion deficit seems likely. For fiscal 1982, the House expects a $31-billion deficit and the Senate a $51-billion deficit, and many private analysts expect a much larger figure. This suggests that Federal demands in credit markets will continue for some time to press upward on borrowing costs — at a time when the Federal Reserve is committed to an anti-inflation objective of gradually and steadily reducing the growth in monetary stimulus.

Need for Spending Cutbacks

The necessity for substantial Federal spending cutbacks is obvious, given the Administration's commitment to significant tax reductions coupled with a massive defense build-up. Understandably, then, Congress is beginning to turn its attention to some politically sensitive entitlement programs — "payments for individuals" — simply because that's where the money is. Aside from defense and interest costs, such payments amounted to 70 percent of total outlays in the last fiscal year. Entitlement programs increased eight-fold over the past decade and a half, and they accounted for virtually all of the inflation-adjusted increase in budget spending recorded over that period.

The upsurge in these programs reflects the fact that roughly 90 percent of payments to individuals are now subject to indexation formulas. Indeed, this means further budgetary problems in the years ahead. According to Congressional Budget Office estimates, such

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payments could be $192 billion higher in 1985 than in 1980, and roughly three-fourths of that amount would represent the cost of automatic escalation. The problem is compounded by the choice of an inappropriate index — the consumer-price index, which has overstated inflation by virtue of the heavy weight it gives to current mortgage- interest rates and home prices. (Certainly it's inappropriate for most benefit recipients, who generally reside in rented quarters or paid-up homes.) Indexing will prove expensive in any case, but Congress could limit the damage in various ways which are now under consideration.

Implications for California Financing

These considerations suggest that the biting of bullets will be the major occupation of fiscal planners in Washington this year. But that should be doubly true of legislators here in Sacramento and elsewhere in California, because of the interaction of the national, state and local fiscal crises. California's governmental units are limited by voter-imposed limits on taxing and spending, and by the slowdown in revenues brought about by a business slowdown — and stymied also by the disappearance of formerly massive state surpluses. But now, in addition, California's governments must come to terms with the national administration's attempt to transform the nation's fiscal structure by reducing state-local transfer programs.

For the nation as a whole, the Administration has proposed cutting $14.5 billion from Federal funds flowing to state and local governments in 1982 — starting a cycle which could lead by 1984 to a 30-percent reduction (in real terms) in grant programs. For California, that would soon mean a reduction of about 30,000 CETA public-service jobs, as well as cutbacks in certain transportation, health and other programs. Such

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cutbacks of course would aggravate the state's fiscal crisis, brought about by the disappearance of the massive surpluses that cushioned the blow dealt to local-government finances by the passage of Proposition 13. As you know, the Governor's proposed budget for the 1982 fiscal year calls for only about a three-percent spending increase over this year's total, compared with the 18-percent average annual increase of the past eight years. For all those reasons, midnight on June 30 is likely to be a very interesting time in Sacramento. And there's little consolation in the fact that the scene will be repeated in 49 other state capitals and innumerable city halls throughout the nation.

What can be done to remedy the situation? One time-tested solution would be to raise taxes — such as the proposal to raise sales taxes as part of a crime-fighting program, or the proposal to raise gasoline taxes and auto-license fees as a means of rescuing the state's troubled highway program. That approach is limited, however, in view of Proposition 13-type restrictions on tax increases, not to mention the public's present aversion to any kind of tax increase.

Another possible solution would be to revise the indexing of state income-tax brackets to inflation. Indexing, although desirable as a means of limiting the impact of inflation, has been responsible for a sharp reduction in state revenues over the past several years. As you know, tax brackets in the past two years have been fully indexed to the California consumer-price index, but are scheduled to be only partially indexed next year. Something can be said for partial rather than full indexing, because of the over-weighting of housing in the consumer-price index, but the general principle of indexing now seems to be enshrined in California's tax code — and according to the Administration's plan, may

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eventually be enshrined in the national tax code as well.

Yet another approach would be to limit the indexing of payments for certain transfer programs, which accounted for two-thirds of last year's $2.1-billion state budget increase. That approach should be just as valid on the state level as on the national level, but of course would be politically difficult to implement.

In the last analysis, however, the fiscal crisis in every governmental jurisdiction can only be overcome through a balanced fiscal and monetary attack on inflation. A reduction of inflation, by fostering lower interest rates, would mean much lower costs of state and local borrowing. A reduction of inflation also would reduce the heavy impact of indexing on state revenues and expenditures. Indeed, consumers here and elsewhere should benefit just as much from a drop in inflation as from a massive tax cut; for example, just reversing the past half-year's rise in the consumer-price index would mean more than a $40-billion improvement in the real income of the nation's households.

Concluding Remarks

In concluding, I would emphasize again the structural changes that will be affecting the economy through the national drive to re-arm, to re-energize, and to re-industrialize. In most respects, those changes will bolster California's future growth. But here and elsewhere, some workers and some firms are likely to suffer in the necessary transition to an investing from a consuming society. In any event, those changes can best be handled in a non-inflationary environment, such as the Federal Reserve is attempting to create.

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Monetary policy cannot handle the anti-inflation fight alone, however. Fiscal restraint is also necessary at all levels of government. In that regard, I'm reminded of the brilliant one-liner that the President made the morning after he was wounded, when an aide reported, "You'll be happy to know that the government is running normally." To which the President replied, "What makes you think I'd be happy about that?" Well, this year provides the opportunity for every legislator and every government official in the country to disprove the old stereotypes, and to prove that they can make the hard decisions which will help cure the nation's fiscal and economic crises. I'm confident that we'll all be able to meet the challenge.

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