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Statement

By

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before the

**Subcommittee on Forests
of the Committee on Agriculture**

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I am pleased to discuss with you this morning the present state of the housing and forest products industries and the outlook for the future. My testimony will review briefly the current economic and financial situation, discuss the origins of the problems facing housing and related industries, and indicate what I believe to be the appropriate course for government policy during the period ahead.

The problems of the housing industry and those that supply it are part of a broader economic malady. We must keep that carefully in mind as we look for solutions. Quick fixes tailored to specific industries could prove illusory, and counter-productive over the longer term, if they diverted us from attending to the broader policy needs of the national economy.

We are now in the process of reversing an inflation that began in the middle 1960's, and steadily worsened until it threatened to bring serious harm to our economic institutions. This effort has imposed substantial costs in terms of reduced output and employment, economic hardships for individuals and families, and declining sales and profits for many businesses. It is clear that the credit dependent housing industry and industries related to it have suffered disproportionately. It also is clear, however, that these industries have as much to gain as others--if not more--from a successful effort to restore price stability. We have made substantial progress during the past two and a half years in reducing inflation. Price stability, lower interest rates, and a healthy

economic recovery are all achievable. We in the Federal Reserve will persist in our policy of monetary discipline, and if the Congress and the Administration are successful in their efforts to reduce the deficit in the Federal budget, fiscal and monetary policy will be working together to defeat inflation.

The Current Economic Situation

The nation has been in the grips of an economic slow-down for some time. The recession began in the housing and heavy durable goods industries, but it has since become widespread among industries and geographic regions. Nevertheless, those components of the economy most heavily dependent on credit have been affected the longest and most severely. By late last year, housing starts had fallen to the lowest level since World War II, and output in sectors closely related to housing--such as the forest products industry--has contracted sharply. The auto industry and producers of business capital equipment also have been hit hard.

The hardships resulting from high interest rates have not stopped at our national borders. High interest rates have had substantial adverse effects on borrowers abroad, reflecting the increased economic interdependence of nations and the growing integration of international capital markets.

The human costs of the recession have been serious. The overall unemployment rate has reached a post-World War II high of nearly 10 percent, directly involving more than 10 million people. The fact that the recession has been most severe in the construction

and durable goods industries means that the burden of rising unemployment has been relatively heavy on adult men, although joblessness among young and inexperienced workers also is relatively high. In addition to those officially recorded as unemployed, there are hundreds of thousands of discouraged workers who want work but have given up looking for jobs.

Economic and personal hardship has been particularly severe in those areas of the country where the most depressed industries are concentrated. Employment in the auto industry--which is facing both cyclical and structural problems--has fallen by nearly a third during the past several years; in July, the unemployment rate in Michigan was almost 15 percent. Because of the massive downswing in national housing activity, scores of lumber mills have been closed or have curtailed operations, and many thousands of employees have been laid off or had their workweeks cut in the west and south--the nation's major forest products producing areas. In Washington and Oregon, for example, the number of persons employed in the lumber industry during the second quarter of this year was almost 30 percent below the level four years earlier.

Economic and financial market developments have taken a heavy toll on individuals and institutions in a wide range of other industries as well. We have seen bankruptcy or reorganization of a significant number of major corporations and a large number of small businesses. Business failures, in fact, have climbed to the highest levels since the 1930's; even when measured relative to the

total number of concerns in operation, business failures are the highest in several decades. And the substantial rise in market interest rates since 1978 has placed serious strains on many financial institutions, particularly those that traditionally have supplied the lion's share of housing credit. Many thrift institutions that relied on short-term deposit funds and made long-term, fixed-rate mortgage loans have encountered severe earnings and net worth problems. Strenuous efforts by the regulatory agencies have been required to support capital positions and to help arrange appropriate mergers and acquisitions of financially troubled firms. There were about 300 mergers in the S&L industry during 1981 and roughly 250 have occurred so far this year, quite a few of which were arranged or assisted by the regulators.

There is some evidence suggesting that the recession of 1981-82 is now behind us. Real GNP increased somewhat in the second quarter, when the rate of inventory liquidation exercised less drag on the economy than it had in the first three months of the year. Moreover, the index of leading economic indicators has moved up for several months in a row.

Yet, there is little evidence so far that recovery is under way. Labor markets continue to be unusually weak; consumer spending remains sluggish, and business fixed investment is declining substantially.

My judgment is that a pickup in activity is likely to develop in the months ahead, bolstered to a degree by the mid-year tax cut and the effects of the recent drop in market interest rates.

History suggests, moreover, that some momentum will develop once an upturn is in process. But the toll of three years of financial and economic stress will limit the pace of recovery for a while. Business capital investment is perhaps the major point of vulnerability. Current and planned outlays for plant and equipment have continued to decline substantially; both domestic and export markets are weak; capacity utilization is low; temporary overbuilding of offices and stores has appeared; operating profits of nonfinancial corporations have fallen to a postwar low, and the illiquidity of many firms is likely to discourage businesses from making long-term investment commitments. Housing is not apt to contribute to cyclical recovery to the extent that it has in past upswings, at least not until long-term interest rates decline considerably further. The overall pace of expansion during the first several quarters of recovery, therefore, is apt to be a good deal weaker than has been typical of postwar recoveries from recession.

Sources of the Problems

Two factors are primarily responsible for the current condition of the general economy and the credit-dependent sectors such as housing. The first is the strong inflationary momentum that built up over the past 15 years or so. The second is the mix of public policies that has been in place during much of the past several years.

Toward the end of the last decade, there was fairly general recognition that inflation had been allowed to get out of

hand, and that it was seriously damaging our economy. Fighting inflation came to be recognized as the top priority for economic policy. In late 1979, the Federal Reserve moved to ensure the monetary discipline that was needed if inflationary pressures were to be contained. Unfortunately, for a time the System carried on that battle largely alone. Large and growing budget deficits created a serious imbalance in fiscal policy, contributing to extraordinarily heavy pressures on financial markets and record interest rates.

Let me remind you of the serious state of the Federal budget at midyear 1982. Leaders from the administration and the Congress agreed that, under current law and assuming the President's proposed defense buildup, the deficit in fiscal 1985 would exceed \$230 billion if the economy grew reasonably well--that is, at an average rate of 4 percent a year--over the 1983-85 period. The deficit in fiscal 1985 would then be about 5-1/2 percent of GNP, by far the largest of any postwar year. Since net private savings historically average around 7 to 8 percent of GNP, a deficit of this size would absorb roughly three-fourths of net private saving, leaving precious little to finance net private investment in business capital and housing.

Even under the best of circumstances, bringing an end to an inflation that had gone on largely unchecked for a decade and a half was bound to be painful. But the threat that monetary and fiscal policies might collide head on made it doubly so.

Since midyear, interest rates on short-term securities have come down dramatically, and improvement has also occurred in those interest rates that have such an important bearing on the pace of economic activity--that is, on corporate bond rates, mortgage rates, and the rates paid by business borrowers at banks.

These developments reflect, in part, a recognition by financial market participants that the recovery in economic activity likely to develop over the rest of 1982 and on into 1983 will be comparatively weak. They also stem, however, from the improved prospects for budgetary discipline and a growing realization that monetary restraint has contributed importantly to reduced inflation.

In 1979 and 1980, the long-term trend rate of price increase was probably in the neighborhood of 10 percent. With food and energy prices rising rapidly at that time, actual inflation rates were above 12 percent. Since then, the underlying trend rate of price rise has, I believe, been cut nearly in half--largely because there has been some moderation in the rise of wages and salaries. Improvements in productivity introduced by business firms may also be helping to moderate inflation. Moreover, we are benefitting on the inflation front from the continued glut in world oil markets, from the improvement in the value of the dollar abroad, and from harvests of major grain crops that will apparently be very abundant.

Slower inflation has helped to take pressure off financial markets, by reducing demands for money and credit and by lowering

the inflation premium contained in nominal interest rates. The longer that improved price performance is maintained, the greater will be the confidence of private market participants that a decisive downtrend in inflation is being achieved.

Sentiment on financial markets has also been improved by evidence that the political logjam that appeared last spring to be holding up progress on the budget has broken up. Passage of the tax bill has not ended the need for concern about federal deficits and the threat they contain for financial markets and for private industries most heavily dependent on credit. But it does suggest that the clear and present danger of a burgeoning deficit is widely recognized, and that the process of reducing the government's absorption of credit is now under way.

Future Prospects and Policies

Let me turn, next, to the policies that are most likely to be successful in helping to restore health to all major segments of our nation's economy.

The fight against inflation has been long and arduous. There is a temptation, therefore, to become impatient, and to adopt a course of economic policies designed to encourage greater strength of recovery in the near term. It would be premature, however, to declare the battle against inflation won. Inflationary expectations remain powerful, despite recent progress on the price front, and downgrading of the inflation problem as our top priority

could mean that the costs borne to this point would have been largely wasted.

Indeed, I would argue that the single most important thing government can do for the benefit of housing and related industries is to pursue policies that will get rid of inflation once and for all. Inflation produces the high interest rates that cause ratios of monthly payments to borrower income to rise to prohibitive levels during the early years of the home mortgage contract. Expectations of inflation also cause prices of houses to shoot up faster than prices of consumer goods and services, making it more difficult for first-time home buyers to meet monthly payment and downpayment requirements. During the latter part of the 1970's, for example, average home prices were rising at rates of nearly 20 percent per year, roughly twice the pace for goods and services generally, or for personal income.

Inflation can be disastrous for rental housing, a particularly important alternative for our less affluent citizens. The production of apartment structures for rent has been depressed for many years, even as vacancy rates have fallen to historic lows. Investors have been unwilling or unable to take on the risks of rental projects for which it is quite difficult to predict returns, especially when local governments might abruptly impose controls on the rents that can be charged.

We must have a sensible, coherent, and unambiguous set of federal policies to achieve a sustained economic recovery unhampered

by resurgent inflation and heightened financial pressures. The Federal Reserve is fully cognizant of the need to follow policies that will permit a healthy and sustained economic recovery. But we have no intention of abandoning the basic monetary discipline that is needed if we are to achieve that goal. We recognize that excessive monetary growth would simply embed inflation and inflationary expectations more deeply in the economic system, ultimately pushing long-term interest rates to levels that would exacerbate the problems of housing and housing-related industries.

Our nation also badly needs actions to achieve smaller "structural" federal deficits--that is, to assure that deficits will decline as the economy recovers. The Congressional budget resolution was a welcome show of determination to achieve a sounder fiscal policy, and the recent tax bill was a concrete step toward implementing the needed budgetary restraint. But a great deal more needs to be done as the economy expands. Indeed, even if the objectives of the budget resolution are fully reached, the deficit appears likely to be higher in the next several fiscal years than in the current year, despite the fact that the economy will be expanding. Of course, some of the fiscal 1983 deficit will reflect the economic weakness this year and the time required merely to regain lost ground. But abstracting from those factors, a structural deficit problem will remain to be dealt with, even if all of the deficit-reducing measures in the budget resolution are enacted.

If we do not take strong steps to deal with this budget problem, continuing federal deficits will preempt an excessive share of net savings generated by the private sector and, in the process, place renewed pressures on credit markets when the economy starts expanding. This prospect, of course, also influences the attitudes of both borrowers and lenders, limiting the decline in long-term rates of interest needed now by credit-dependent sectors such as homebuilding. A credibly firmer budget posture is needed to promote confidence that fiscal and monetary policies are working together in fighting the battle against inflation.