

**REFLECTING ON RECESSION, ENERGY, AND INFLATION**

**Remarks**

**to**

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**by**

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At the turn of a decade, tradition suggests polishing the crystal ball with extra care. The last decade proved difficult for the world economy. Many major events of the 1970's were not seen by economic forecasters ten years ago. It is unlikely our clairvoyance has improved with the passage of time. Who, for example, could have predicted the recent events in Iran and Afghanistan?

Even one year ago, forecasters believed 1979 would be a recession year. But real economic activity increased in the third quarter and early indications are that activity also increased in the fourth quarter. If true, that would leave only the second quarter showing a decline last year.

In my remarks to you last January, the likelihood of a recession was discounted. However, I did expect the economy to weaken. Now, the growing number of persons laid off and the weakness in industrial production toward the end of 1979 give credence to those who think a recession is near.

Recessionary forces are scattered, but show their greatest strength in the Midwest and Northeast sections of the country and in the automotive and residential construction sectors of the economy. Strength in these sectors fed the four-year-old boom; now, this strength has declined and the boom is starving.

We know the reasons: the substantial increase in automobile prices, especially small automobiles, encouraged drivers to keep their old cars. The escalating cost of gasoline turned the romance Americans had with big automobiles into something more on the order of disaster. Small, gas-thrifty American cars are not yet plentiful enough to fully accommodate that market.

Then, there is the stubborn decline in housing activity. Mortgage rates and prices of homes rose beyond the reach of many first-home buyers. Considering the high cost of mortgage money and the slackening amount of mortgage funds available, a cutback in residential construction was inevitable. This sector is not likely to show strength until the depressants are removed, and that might not happen before late in 1980.

Looking to the future, two questions surface most often: How mild will the recession be? How long will it last? Forecasters almost unanimously expect the current downturn to be milder and shorter than the 1974-1975 slump. That downturn was the most severe and longest since World War II. It lasted 16 months; and GNP, adjusted for inflation, fell 5 percent during the period.

There is ample reason to expect history will not repeat itself. Then, the market for condominiums and apartments was saturated, and speculation was rampant. Today, builders are better positioned. Inventories of unsold homes are low, and the demand for homes as a hedge against inflation is strong. All indications are for a modest decline in housing, not a collapse.

There are other differences. First, there was a credit crunch in 1974. Now, business credit is available, though costlier and less plentiful than before October 6 when the Federal Reserve started to restrict bank reserves. Second, in 1974-1975 inventories were excessive throughout the economy. This time, businessmen have kept inventories lean and, with minor exceptions, inventories seem much better balanced relative to sales. These contrasts between the 1974-1975 slump and present conditions indicate the 1980 recession may be less harsh.



Many analysts foresee the 1980 downturn as mild, or, at worst, a typical post-World War II recession: that is, it would last eleven months, and real GNP would fall about 2 percent between peak and trough of the economic cycle.

Is this prospect realistic? At quick glance, it is appealing and not altogether unreasonable. Still, this prediction of a very mild recession has some skeptics.

Changes have occurred in our economic structure and labor force size since the Fifties and Sixties, when recessions were just small interruptions to rapid growth. The present economy is much more dependent on world trade and has greater links to international events. More complex and heavily service-oriented, its demographic composition is different. The country's population is getting older, with fewer youths and more retirees. Fewer people marry. Those who do have fewer children. More are getting divorced. There are many more working women. The list of changes is long.

Two overshadowing components of the changing economic environment are energy and inflation. The alarming facts about our energy situation are that our oil imports have increased during the Seventies, but our own oil production has declined despite Alaska's output. Earlier it took 4-1/2 years for gasoline prices to double, but only recently they doubled in 18 months. The gas mileage of the average American car on the road today increased only eight-tenths of a mile from six years ago. Compared to other countries, our oil needs are so large but our strategic petroleum reserve is so small that we are vulnerable to even modest cutoffs in oil supply. These problems are not likely to be solved in the 1980's. No amount of conservation, synthetic fuels, or energy alternatives will give us relief in the short run.

Nor can we expect any dramatic relief from the ravages of inflation this year. Besides inevitably higher gasoline, heating oil, and utility bills, in 1980 we face the prospect of a wage catch-up. Two-fifths of all collective bargaining contracts are up for renewal, and unions undoubtedly will work hard at offsetting the loss in consumer buying power. The minimum wage hike also will push up labor costs.

Another part of the inflation problem -- the federal deficit -- is certain to rise. Federal budget deficits always widen in recessions as tax receipts slow down and unemployment compensation and public works spending expand.

The effect of inflation on persons with fixed incomes is well known; the effect on savers is less obvious but extremely serious. Inflation discourages the incentive and ability to save. The average American now saves less than 4 percent of his income -- the lowest level since the Korean war. He has been borrowing at record-breaking rates, using credit cards and numerous other devices. More and more, he expects his savings to come from profits on real estate, gold, and commodities. If he is a homeowner, he can usually take advantage of capital gains on his old house, spend some of the proceeds, and get a new, inflated mortgage.

An individual may possibly succeed by this process if his assets keep rising in value. A nation cannot. Less saving means less investment; less investment means less chance of reducing inflation. Our rates of savings and of investments are among the lowest in the world. Other nations have surpassed us in research and development and investment breakthroughs, which are the path to lower costs. Our productivity gains in 1979 were extremely low, or even negative, and our inflation was above much of Western Europe's. Less saving and less investment make for a vicious cycle of inflation.



Nevertheless, there is a chance inflation will ease off later this year, perhaps even to a single-digit figure. Inflation typically slows during recessions since these are periods of slackening demand, making price rises difficult. Employment falls off, causing those with jobs to work harder. Profits are reduced encouraging management to adopt more conservative business practices.

Last October the Federal Reserve took various credit-tightening steps because excessive money and credit were hindering the anti-inflation struggle. These actions met with some success: money and credit growth diminished. So, a slight lowering in the inflation rate as the year unfolds is a possibility. If oil prices could be brought down or moderated, these prospects would be much brighter.

I am less optimistic than most of the forecasters when considering the future of business activity. The current downturn could go somewhat deeper than most anticipate, especially given another oil cutoff or huge OPEC price increase. Money we pay for imported oil means that much more money goes abroad, leaving less to spend in this country. Reduced consumer spending on non-oil products at home, in turn, means less goods are produced domestically. The result: fewer jobs, threatening a deeper recession.

The consumer price rise has outstripped income growth, resulting in 5 percent less real disposable income for the average consumer from one year ago. The modest wage increases last year for the average American were more than wiped out by inflation and higher taxes. The significance is that it could force consumers to trim their buying. If indeed consumers do become less inclined to incur debt and start saving more of their paychecks, retail sales could suffer. Goods would pile up on shelves quickly, causing inventory corrections, order cancellations and layoffs.

Capital spending falls substantially in a severe recession, although it holds up well in a mild slump. Thus, we could see a scaling back in capital outlays as business executives delay spending plans -- especially for equipment replacement -- until retail sales recover.

If consumer spending falters in this election year, fiscal stimulus is almost a certainty. Our elected officials would be reluctant to resist a tax cut and stepped-up government spending. But election day is less than ten months away, and it may be too late for fiscal stimulation to have more than minimal impact on jobs and income during most of 1980.

Our economy differs from past decades. Traditionally, we apply monetary discipline to curb inflation, and fiscal stimulus to fight recession. These policy weapons have serious drawbacks for application today. Both work primarily on the demand side for goods and services.

A tight monetary policy is appropriate in the current environment. Credit restrictions reduce demand pressures and, therefore, will normally slow inflation. But when so much of the inflation is caused by OPEC and cost trends, it might take a bone-crunching, supertight monetary policy to reduce demand enough to check inflation. The price for such a policy -- namely, a prolonged, deep recession -- would be unacceptable to all of us.

Another traditional tool, fiscal stimulus, is used to push the economy ahead, stimulating demand. An across-the-board tax cut would increase consumer spending, but inadequate demand is not our major problem today as it was in the depression of the Thirties. In fact, consumers have been buying ahead of their needs, anticipating higher prices. Some still do.



The wisdom of stimulating consumption with a tax cut for consumers is doubtful. In times of little inflation, personal tax cuts can be defended because of their short-term benefits to employment. But that is not the current need. As a whole, our society has been hurt too severely by inflation to risk reversing anti-inflationary policies now. Our greatest concern should be with supply rather than demand, especially in the field of energy.

The concern with supply spotlights long-range problems that have only long-range solutions. Appropriate programs must be found on which there is a consensus. This is always difficult. Here are some suggestions: a reduction in burdensome government regulations, a modification of laws and rules that stifle competition, and a balancing of the federal budget.

Tax reforms, which will support capital formation, could be added to this list. Also, there is a need for displacing obsolescence in our economy. Productivity improvement, which ultimately leads to lower costs and prices, can come only from more efficient machinery and facilities.

Although it may be difficult in an election year, we must take a long-range perspective in dealing with our economic problems and worry less about the near term. Basically, we need an effective long-range energy program. A reduced dependence on imported oil and increased efficiency in use of energy could reduce inflation substantially.

For those of us responsible for monetary policy, the message is clear. The Federal Reserve, without wavering from its policy stance, should stand firm against the philosophy that inflation will forever remain a way of life in our society. This means rejecting rapid money growth to boost the economy during recession. An expansionary monetary policy increases inflation in the long run and could bring fresh assaults on the dollar in the foreign exchange markets. This we can ill afford.



A steady reduction in money and credit growth in 1980 is a prudent policy. Acceptance of this policy also means acceptance of some risk for a painful recession, but it would be a step toward our goal of gradually bringing down inflation.

The message is simple. The recession probably will be milder than the 1974 downturn, and the inflationary fever should diminish slightly. Our recognition that inflation and energy deserve highest priority means hope for a solution to these vexing economic problems. They are deep seated and tenacious. Solving them will require time, patience and a few modest sacrifices. Part of that price may well be a willingness to forego some short-term gain in exchange for a more secure, more stable and healthier economy.