

Remarks by

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I'd like to talk about the tax cut that's being proposed, because I have a feeling that whether we recognize it or not, that has some rather interesting implications for banking. And I think that if I'm right, they're going to be implications that neither you nor I will like very much. Just by way of introduction, virtually everybody I know thinks that it would be desirable to have a tax cut at the federal level. And the only debate seems to be: should it be \$25 billion or \$15 billion or \$50 billion. There really doesn't seem to be much debate at all as to whether it's desirable to have the federal government reduce taxes. I'd like to suggest that maybe we ought to analyze that a little bit more carefully before we jump on that bandwagon.

Some people argue in favor of a tax cut because they think it will help to reduce the size of government. And they argue rather strenuously that government is too big and involved in too many things, and therefore if we can reduce taxes, that will provide a way of reducing the size of government and its interference in our lives. Well, I would like to agree enthusiastically with those who think government is too big. I would like to agree enthusiastically with those who say that government ought to get out of our hair. But it's not clear to me that reducing taxes in any way will impact on the size of government. I don't hear many saying that we ought to reduce expenditures as well as taxes. What we hear is that we ought to reduce taxes. So I'm not at all optimistic that the political process, at this point in time at least, will lead to a smaller government as a consequence of a tax cut.

Well, if you don't have smaller government, if you don't have fewer expenditures, then what you have is a larger deficit, and that's what makes me concerned about the possibility of a tax cut.

To show you why, let me review the second basic line of argument in favor of a tax cut, and that goes something like the following: the economy is strong, but it doesn't look quite so strong in the second half as the first half. Unemployment is unacceptably

high; therefore, we need to stimulate the economy by additional deficit spending so the economy can continue to grow and unemployment will fall. And we can do that, so the argument goes, with relatively little impact on inflation.

I think there is a very significant possibility that that line of reasoning is incorrect and that the larger deficit that we'll get from a tax cut will have implications quite different from those that I've just outlined.

The economy at the moment is very strong. I think we'll find by the time the numbers are in for the first quarter of this year that the economy has grown at a very rapid rate. The expansion is strong and it has been strong for a relatively long period of time. We're now going into the fourth year of this expansion, and it has been a very unusual expansion from two points of view. One, it has been very long already; and two, it has been much more balanced than expansions normally are. That is to say, often in the past when we've had an expansion we've had a very aggressive expansion, a lot of capital spending, investment spending, consumer spending, and so on. And then the boom goes bust, and we go down into a recession. This time we've had strong consumer spending, strong government spending, relatively strong but not booming business spending. And unlike many people who exhibit great concern about the lack of business spending, I believe that from a purely economic point of view in terms of growth of the economy, the moderate rate of business spending has actually been a real plus because it has kept the economy from booming and going out of hand and thereby generating a contraction. Now, there's no question that we need to have business spending increase, for our long-run needs as well as for the continuation of the current expansion. But up until now the kind of business spending we've had, in my point of view, has really been quite satisfactory.

So we have had a strong economy, we have had significant economic growth—faster, by the way, than in most other recoveries. Unemployment has indeed come down, not as much as we would like, but it has come down significantly. We often lose sight of

the fact that by focusing on the unemployment rate, we fail to give sufficient notice to the number of people who are actually working. And we now have a larger percentage of the work force working than at any other time in the post-war period. Since the expansion started, the private economy has generated 8 million new jobs. Last year alone almost 4 million jobs were generated by the private sector of our economy, a prodigious number of new jobs. The reason the unemployment rate has stayed as high as it has is because along with this tremendous expansion and increase in the number of jobs, we've also had an unprecedented flow of new people into the labor force, primarily teenagers and women. And a statistical fact is that teenagers and women tend to be unemployed on average for a longer period of time than men are, and therefore the measured unemployment rate, which is what we have, is higher than it otherwise would be. One way to look at that is whereas we used to think of full employment as 4%, with the change in the composition of the labor force, full employment is probably a lot closer to 5½%, or even a little higher, than it is to 4%. So the point is that we've had a tremendously strong expansion, a very balanced expansion, and as far as we can tell, looking into 1978, the expansion should continue at a very satisfactory pace. As we look at each of the segments of the economy—the consumer, state and local governments, federal government, construction, business spending, and so on—we see very strong signs, so we would expect the economy to continue to grow through 1978. And we would expect unemployment to continue to decline modestly as it has over the past year.

Last year at this time, people were calling for a tax cut. That was the \$50 rebate idea. That idea was eventually abandoned, and as it turned out, it's a good thing it was because the economy did perfectly well without it. It seems to me that there's a good possibility that the same thing may happen this year. We'll have a very strong first half and a perfectly fine second half, and therefore the needed tax stimulus that people are talking about just won't prove to be necessary.

If that's all there were to the story I wouldn't be taking all your time to discuss it. I think there's a much more significant element than that. And that is, the one thing on the horizon that is the most disturbing in my judgment, the outlook for inflation. If you look at the paper, or you listen to the radio, or you listen to people talk, you're beginning to hear statements like: "Well, of course, inflation will be 6% during 1978, or maybe a little higher." You don't have to go back many months, in fact about nine months to be exact, to the time when people were talking about inflation which had come down from double-digit numbers, down to a little above 6%, and people were saying that the rate of inflation would continue to decline. When I came to Minneapolis in April, the standard forecast was that inflation would move from 6% to a little lower than 6%. Now people are saying we will have to struggle to keep the rate of inflation at 6%, and it may well be higher. I think there's a very good chance that it will be higher, and I think that a tax cut in the absence of a reduction of expenditures at the same time will virtually guarantee that the rate of inflation will be higher than 6%. Let me just spell out briefly how I think that will work.

The general feeling or expectation which people have now is that the rate of inflation is at a minimum of 6% and is likely to go higher. And this expectation is based on any one of a number of things. It's based on people's perceptions as to what inflation has been in the past, it's based on a lot of specific actions which have taken place—farm programs, sugar quotas, minimum wage legislation, restrictions on imports, a whole series of things which to different people mean that domestic prices are going to be higher than they otherwise would. It's common knowledge that the money supply grew at over 8% for the last nine months of 1977. And to top things off we're now looking at a federal deficit of \$60 billion in the fourth year of a very strong economic expansion. In my judgment, a \$60 billion deficit at this stage of the expansion is just way too much and is going to guarantee an acceleration in the rate of inflation.

When labor sits down to negotiate their labor contracts, when businessmen sit down to price their products, they don't do that in a vacuum. They don't make unrealistic assumptions. What they do is say, "I wonder what the rate of inflation is going to be. And if everybody says it's going to be 6%, then I've got to get at least 6% plus. I've got to have at least the 6% just to stay even, and then I need a little more so that I make progress." And that's a perfectly reasonable thing to do. The difficulty is that when businessmen and labor and others sit down during 1978, and they look at all those things I've just mentioned—the specific causes of inflation and the general causes of inflation—they're now saying, "We've got to have at least 6%, maybe 6½%, in order to keep even with inflation, and then we'll need a bit more so we get our share." And of course as everybody does that, we don't get 6% inflation, we get 6½% or 7%. Then the next time people sit down they say, "We've got to have at least 7% to keep even plus our share." So they take 7% plus. The resulting inflation rate is not 7%—it rises to 7½% or 8%. The whole thing just keeps feeding on itself as long as we allow it.

In that kind of environment it seems possible—in fact, I think very likely—that if we have an increase in the size of the deficit (which is all a tax reduction is going to do), this in turn will lead to expectations of more inflation which in turn will lead to more inflation, with little if any impact on unemployment. That is not a very happy outlook for the country or for banks, because as the central bank does what it can to moderate those inflationary pressures that will mean higher interest rates. So it seems to me that there's a very good possibility that once again we will repeat what by now is a tired old scenario where we have fiscal ease, large government deficits, monetary restriction in order to try to counterbalance the inflationary implications of those fiscal deficits, and banks and the public are just in the middle. What the public doesn't understand about bankers is that bankers, probably more than anybody else, would prefer to have lower interest rates rather than high interest rates because it's precisely in periods of high interest rates when your business gets caught in a squeeze.

Well now, what's going to happen? I go all around the country saying that I think we ought to be careful about a tax reduction, that we ought to be careful or we're going to have inflation begin to move upward on us again. And I suspect a few people would nod their heads yes, a lot of other people would shake their heads no, and the result is that we're going to have a tax cut. And my guess is that as a result of that tax cut, we're going to have more inflation. It follows then, in my judgment, that during 1978 and beyond you're more likely to see interest rates move higher than you are to see them move lower. In fact, it wouldn't surprise me if, because of inflation, they move a lot higher than any of us would like.