Research Department
Federal Reserve
Bank of
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Countering the Threat

The 1980's have already been labelled "The Dangerous Decade"—and if anyone doubted that point, he would have been convinced by the new onslaught of inflation which affected the national economy in the very opening months of the new decade. Last week-end, in an unprecedented step to counter the threat, the Administration re-opened the books on its 1981 budget document only a month and a half after sending it to Congress, and announced a series of spending cuts and revenue increases designed finally to bring about a balanced budget in the new year. In a companion measure, the Federal Reserve announced a series of steps to make credit more costly and less available, thus supporting the Fed's major credit-tightening move of last October 6.

The Administration originally had projected a $16-billion deficit for fiscal 1981, but the financial markets reacted adversely to the continued diet of red ink, especially since some estimates had suggested that the actual deficit would be almost twice the Administration's estimate. Hence, the President moved last week-end to bring an inflation-fighting balanced budget within sight again, by cutting at least $13 billion from planned Federal outlays, and by imposing a $4.64-per-barrel "gasoline conservation fee" on imported oil. In addition, the President imposed an immediate freeze on government hiring, and asked Congress to institute withholding procedures for dividend and interest payments.

Fed's response

The Federal Reserve already had moved to counter inflation last October 6, when it announced its resolve to slow the rate of monetary growth, and introduced new operating techniques designed to reach that goal. The new policy steps, in what could be called a 9-10-15-16 cadence, should help extend the impact of its earlier credit-tightening measures throughout the financial community.

The Fed asked not only commercial banks, but other business lenders as well, to restrict the growth of business lending, so that such loans don't grow faster than the 9-percent top of the range targeted for bank-credit growth. The Board also increased, to 10 percent, the reserve requirement on the growth of "managed liabilities" (such as large time deposits and dollars borrowed overseas), and meanwhile extended that 10-percent requirement to nonmember banks for the first time. To slow consumer-credit growth, the Fed established a 15-percent "special deposit" requirement on certain consumer-related credit extensions of banks, finance companies, retailers, gasoline firms and travel companies—and meanwhile imposed a 15-percent reserve requirement on increases in assets of money-market mutual funds. Finally, the System imposed a 16-percent discount rate (the basic 13-percent rate plus a 3-percent surcharge) on those large banks which resort too frequently to the Fed's discount window—specifically, more than one week in a row or more than four weeks in any calendar quarter.

Cause of problems

The restrictive policy measures imposed at the beginning of the 1980's reflect a necessary response to the dismal economic record of the 1970's. Actually, the record of the past decade in some respects was not too bad. For example, real disposable per capita income—a key measure of individual well-being—increased 28 percent in the 1970's, or almost as much as it did in the 1960's. But the nation ate up much of its seed corn in reaching its higher standard of living. Real business investment increased only one-third as fast, and worker productivity less than half as fast, as in the preceding decade. Worse still, the nation became increasingly dependent for its raw materials on unstable and expensive sources of supply, as evidenced by a 15-fold rise in the price of Middle Eastern oil over the decade.

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The public sector accounted for much of the demand stimulus in the economy during the 1970's, as massive Federal spending increases outpaced tax revenues and created red ink on the books for every single year of the decade. Indeed, the combined Federal deficit for the decade, $315 billion, matched the combined total for the entire earlier history of the Republic. Inflation became an ever-worsening problem, reflecting the prolonged series of Federal deficits, the stimulative monetary expansion that sometimes accommodated them, and a series of supply-related shocks from OPEC oil and other sources. Consumer prices thus practically doubled over the course of the decade, in the worst peacetime inflation in the nation's history (see chart).

Oil-price problem

Much of the 1980-style inflation can be traced to the numbing series of OPEC price increases occuring during the 1970's, which culminated in the doubling (or more) of OPEC prices in 1979 alone. In dollar terms, the U.S. paid about $6 billion a year to the oil exporters prior to the 1973 embargo, but it now is paying them about $100 billion a year for imported crude supplies. The latest price upsurge has meant a 42-percent rise in energy costs for U.S. consumers since a year ago; as well as steep increases for producers which will filter through the economy for some time to come. And despite some signs of a short-term oil glut, the structural changes developing in the international oil market provide little hope of solace for U.S. consumers in the future.

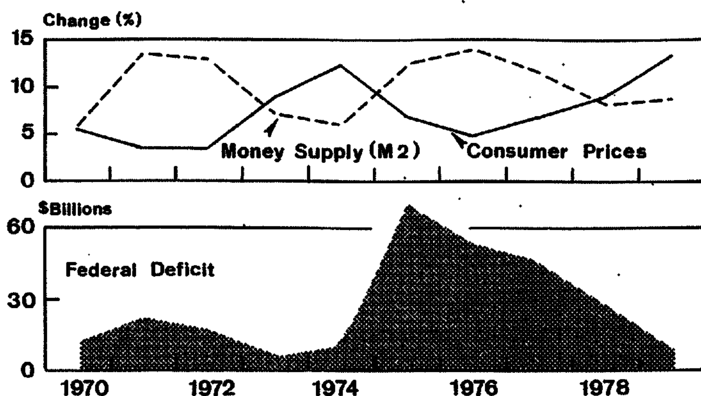
The record of 1979 suggests that an increasing percentage of crude oil will be handled in the future by the producing nations' own oil companies rather than by the major international companies. (Industry sources claim that the major internationals now control distribution of only about 45 percent of OPEC crude—down from a 70-percent share as recently as 1975.) Government-to-government sales thus should increase, bringing about an increased uncertainty of supply. Many more nations could follow the Iranian example, gaining increased revenue even while sharply reducing supply. And a growing number of consuming nations, major oil companies and independents will compete fiercely for available supplies, feeding the price spiral even more.

Nonetheless, the U.S. has already provided evidence that it can adjust to a world of higher energy prices. Even with limited price decontrol, per capita energy usage increased only 5 percent between 1972 and 1978, compared to a 21-percent increase in the preceding six-year period. (In volume terms, that difference amounted to about 6 million barrels a day.) And by decontrolling domestic crude-oil prices—a process to be completed over the next 18 months—the government will be sending consumers an unambiguous signal to conserve, while sending producers an equally unambiguous signal to develop more domestic energy supplies.

Budget problem

Policymakers, while facing the likelihood of ever-rising energy prices, are hence being forced to redouble their efforts to reduce inflationary pressures from other sources. One prime target is the Federal budget, which has aggravated the inflation problem with its deficit-spending stimulus during the recent cyclical expansion. Indeed, much of the current run-up in inflation expectations could be traced to the belief that our budgetmakers had lost control of that engine of inflation.

The fears about a runaway budget surfaced before the ink was dry on the basic document, when it became apparent that Federal spending this year would rise to 22.4 percent of GNP—instead of amounting to a smaller share, as previously believed—and would remain in that neighborhood for several years



more. Some critics complained that the budget would remain unbalanced even in the face of more than $50 billion in tax increases—either from the social-security tax, the windfall-profits tax, or inflation-related boosts in personal-tax revenues. And some observers, when comparing the latest budget document with last year's, noted that projected outlays for 1984 had jumped almost one-fourth, to $839 billion, just within the one-year interval between the publication of those two documents.

Real increases in defense spending make it difficult to reach a balanced budget, which was the primary goal of last week's anti-inflation budget exercise. But many observers are calling on Congress to make even steeper cutbacks than now projected, as a means of reducing the government sector's excessive demands on the nation's resources. The National Association of Business Economists, in a recent study, noted that Congress in 1978 passed five times as many bills that contributed to inflation as did the reverse. Again, the Congressional Budget Office recently listed 58 areas where budget cutbacks were possible—including, for example, the modification of indexing requirements for social-security benefits and other Federal programs, which could yield savings of $70 billion over a five-year period. The problem, of course, is that such cutbacks are as politically difficult to enforce as they are economically necessary.

Monetary response

Monetary policy meanwhile has a crucial role to play in restoring price stability, especially in view of the fact that excess money creation helped create the problem, in the wake of the excess credit demands generated by Federal deficit financing and other forces. Over the 1975-79 business expansion, the M-2 measure of the money supply grew at more than a 10½-percent annual rate—not quite as fast as in the 1970-74 period but half again as fast as in the less inflationary period of the 1960's. Recognizing that price stability requires a progressive reduction in money-supply growth, the Fed moved aggressively last October 6 to enforce its tight-money policy decisions, especially by giving more emphasis to controlling bank-reserves growth, and giving less emphasis to minimizing short-term fluctuations in interest rates. And the policy shift has had good results; the M-2 money supply has grown at less than an 8-percent annual rate since October 6, compared to more than a 10-percent growth rate in the preceding six-month period.

The Fed's basic policy has needed reinforcement, however, in view of the heavy credit demands generated by inflation expectations in recent months. In last weekend's policy statement, the Board of Governors said that "the effectiveness and speed with which appropriate restraint can be achieved without disruptive effects on credit markets will be facilitated by a more formal program of voluntary restraint by important financial intermediaries."

The Fed at that time encouraged lenders to maintain availability of funds to small businesses, farmers, home-buyers and others who don't have access to other forms of financing. At the same time, it discouraged lenders from several types of activities—making unsecured loans to consumers (such as credit-card loans), financing corporate takeovers or mergers, financing purely speculative holdings of commodities or precious metals, or expanding commitments for back-up lines in support of commercial paper. Yet, despite this increased attention to bank lending policy, the Fed continues to base its credit-restraint program primarily on its control of bank reserves and other traditional instruments of monetary policy.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 3/5/80	Change from 2/27/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	138,381	+ 47	+ 15,978	+ 13.1
Loans (gross, adjusted) — total#	116,270	+ 296	+ 16,165	+ 16.1
Commercial and industrial	33,565	− 171	+ 4,351	+ 14.9
Real estate	44,817	+ 102	+ 8,851	+ 24.6
Loans to individuals	24,521	+ 64	+ 3,689	+ 17.7
Securities loans	1,455	+ 71	− 270	− 15.7
U.S. Treasury securities*	6,705	− 222	− 1,035	− 13.4
Other securities*	15,406	− 27	+ 848	+ 5.8
Demand deposits — total#	44,657	+2,485	+ 4,345	+ 10.8
Demand deposits — adjusted	31,531	+1,033	+ 1,732	+ 5.8
Savings deposits — total	27,877	+ 23	− 1,910	− 6.4
Time deposits — total#	59,846	+ 71	+ 9,050	+ 17.8
Individuals, part. & corp.	51,197	+ 130	+ 9,932	+ 24.1
(Large negotiable CD's)	21,329	− 128	+ 2,869	+ 15.5

Weekly Averages of Daily Figures	Week ended 3/5/80	Week ended 2/27/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	71	− 15	9
Borrowings	245	126	82
Net free reserves (+)/Net borrowed(−)	− 174	− 141	− 73
Federal Funds**			

* Excludes trading account securities.
# Includes items not shown separately.
** The revised series on Federal Funds and Repurchase Agreement Borrowings (FR 2415) is available on request from the Statistical and Data Services Department of the Federal Reserve Bank of San Francisco.

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