

WASHINGTON'S FUTURE

Remarks by

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Washington Bankers Convention

Seattle

June 18, 1973

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I'm glad to have the opportunity of being with you today, on my first visit to a convention of the Washington Bankers Association. In fact, I'm much happier to be here now, when we can all bask in the glory of an expanding economy, than I would have been if I had received the invitation during the difficult days of two years ago. That was the time, you will remember, when the national commentators applied the name of the old waterfront-slum area, Skid Road, to the entire regional economy. Yet Washington today is enjoying an economic recovery that few could have foreseen in the summer of 1971, with employment steadily growing and the jobless rate falling all the way from 12 to about 7 percent.

In making my remarks, I do not presume to any detailed knowledge of the state's economy. Yet, as an economist and a central banker, I am interested in isolating the broad trends which are likely to influence the future of a major region which comes under my official purview. To do this, I shall focus on developments in the several major industries which account for the vast bulk of the total income generated by the state's "export" sectors -- that is, the sectors which account for the bulk of out-of-state sales. These are

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aerospace, aluminum, farming, and forest products. Their fortunes, as we shall see, are closely tied to national industries that are themselves susceptible to wide swings in demand -- the air-transport, construction, automotive and machinery industries -- not to mention the volatile foreign markets for food and other products.

Causes of The Downturn

In the late 1960s, as you know, most of the state's major industries bounded forward on a wave of optimism, only to see their hopes deflated one by one. To take the most obvious case, the aerospace industry's fortunes rose and then fell in line with the varied fortunes of the commercial-airline industry. Boeing's resounding success in marketing its 707 and 727 jet transports, and then in developing the 737 and 747 models, was of little avail in the face of the market collapse brought on by the airlines' substantial overestimate of future traffic needs. Other factors turned unfavorable also -- budget cutbacks in the military and space sectors, and then the cancellation of the SST program -- but the major problem was the unreliability of the commercial market.

Disappointed expectations turned out to be the theme for other major industries as well. Aluminum undertook a massive expansion program in the late 1960s, but then went

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through the wringer in the 1970 recession, with its woes being compounded by the General Motors strike and the aerospace downturn. Forest-products firms also had overinvested in new capacity, in addition to environmental outlays, only to find their markets weakening too -- lumber during the boom and tight-money period, and pulp-and-paper during the ensuing nationwide recession. Agriculture, during the late 1960s, had run into trouble because of reduced acreage and lower prices for wheat, as well as weather-caused cutbacks in deciduous-fruit production.

In 1969, the growth of other industries was sufficient to keep total employment growing in the face of the aerospace decline. But during the 1970-71 period, when the aerospace cutbacks grew more severe and the recession extended to other "export" industries as well, employment stagnated or even declined in those important regionally-oriented industries which account for the major share of the state's total employment and income. These sectors include construction, trade, transportation, finance and services. Altogether, the state lost over 80,000 jobs as total employment dropped to 1,268,000 at the recession low, while the jobless rate jumped from 4 1/2 percent at the peak to almost 12 percent at the low point.

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Causes of The Upturn

The record of the last two years has been more heartening, as one by one, each of the key industries worked its way out of its earlier troubles. Agriculture started things off, with a strong performance over the 1969-71 period because of substantial wheat harvests. Then came the spectacular 1972 performance, marked by a 20-percent gain to a record \$1 billion in gross receipts. Wheat, the number-one crop, registered a 61-percent increase last year and accounted for almost one-half of the gain in dollar receipts. During this period, sales to Russia and China not only raised export volume but also gave a strong push to grain prices. Cattle and calves were the second largest source of income, on the basis of a modest gain in production and a sharp upsurge in prices. The apple crop also contributed heavily to the rise in receipts, with prices rising as a result of short supplies in other producing areas of the nation.

The forest-products industry was the next to recover, as strong basic demand and easy financing made possible a remarkable 62-percent jump in housing starts nationwide between 1970 and 1972. Lumber mills in this region increased production by 16 percent over the two-year period, but the pressure of demand kept prices rising steadily except during the 90-day freeze of 1971. Indeed, production probably

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would have expanded further except for the distortions created by controls, since the profit-margin limitation provision of the Phase II program actually discouraged the large mills from producing at full capacity. Pulp-and-paper meanwhile began to recover from its earlier problems of over-capacity and soft prices, and the industry's operating rate approached full capacity by late 1972, under the stimulus of the nationwide business boom.

The Aerospace industry gradually pulled out of its prolonged tailspin over several years' time, although employment today is only half the record high of five years ago. The commercial-aircraft sector, the major cause of the severe downturn, similarly provided most of the thrust for the upswing. In 1972, the nation's airlines recorded an impressive 12-percent gain in passenger traffic and a marked improvement in their profits. In particular, the year's growth brought travel demand closer into balance with capacity, leading to a doubling of Boeing's commercial-aircraft orders. Government orders also supported the upturn, as military prime-contract awards rose 45 percent (although from a relatively low base) during the year.

The aluminum industry, finally, recorded a turnaround in its supply-demand situation during 1972. Producers were able to reopen most of the potlines closed earlier because

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of serious overproduction problems, and the industry's operating rate rose gradually over the course of the year. The deterioration in market prices halted during 1972, and the market then began to strengthen considerably. By the spring of this year, supplies had become so tight that the selling price for ingot finally reached the published level of 25 cents per pound, ending more than three years of heavy discounting.

The Nation's Future

So much for the factors which caused the dismal performance of the state's economy around the turn of the decade, and the factors which then supported the strong recovery we have been witnessing lately. What are the prospects for maintaining the strength of the regional economy over the next several years? Much depends, of course, on the state of the national economy, and for that reason I would like to share with you some of the impressions that the economics staff at my Bank has given me about the probable direction of business over the next year or so, and with which I generally agree.

To begin with, our staff forecast shows GNP rising from \$1,152 billion last year to about \$1,285 billion in 1973 and about \$1,390 billion in 1974. More importantly, the forecast indicates that the economy's real rate of growth,

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after reaching 6.4 percent in 1972 and 6.6 percent in 1973 -- in fact, much higher than that in the first half of this year -- will fall off to a 3.4-percent rate in 1974. What this means is that the pressures generated during the unsustainable and inflationary boom of the past year should gradually disappear, as the economy decelerates and returns to the neighborhood of its long-run sustainable growth path, which is assumed to be about 4 percent a year.

The expected deceleration will occur largely in those investment sectors which have generated so much of the boom atmosphere of the recent past. In 1973, dollar outlays for business structures and producers' durable equipment may increase by 15 percent and 12 percent, respectively, as businessmen struggle to meet heavy consumer demands by going into the marketplace themselves, and buying more stores and factories and all the equipment necessary to stock those facilities. By next year, however, these outlays should be growing at a much slower pace, because of businessmen's success in catching up with their customers' demands.

The boom in autos and other consumer durable goods should also recede in the coming period. Spending in this sector could rise by 10 percent or more this year, after an even stronger gain last year, but a substantial slowdown

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in the growth trend seems reasonable in view of the abnormally high growth rate of recent quarters. It also seems reasonable because of the heavy debt-repayment schedules which many consumers must now face.

Residential construction, the main support of the early stages of the boom, promises to be one of the weakest sectors over coming quarters. In contrast to the massive increases of the past two years, housing expenditures may rise no more than 4 1/2 percent this year, and could show a decline of like magnitude in 1974. Housing starts are expected to fall at an even steeper rate, although some of the drop in numbers will be offset by a rise in construction costs. The projected decline is tied in with the fact that the high rate of homebuilding over the last 2 1/2 years, including the large number of units currently under construction, now appears to have outpaced basic demand by at least a modest margin.

Despite the overall deceleration that we foresee -- and the actual decline in homebuilding -- dollar spending should continue to increase significantly because of the usual up-trend in most types of consumer spending and also in state-local government spending. Also, in some sectors -- such as export demand -- the projected increases for 1974 would appear modest only in comparison with the spectacular gains already obtained.

The 60-day price freeze announced by President Nixon on June 13 should have little effect on the overall level of real economic activity. In this latest action, prices were frozen

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at levels no higher than those charged in the first eight days of June, the only exceptions being rents and unprocessed agricultural products. The freeze will last for a maximum of 60 days, after which Phase IV will be introduced, with the aim of tightening existing standards and requiring more mandatory compliance procedures. Raw agricultural products have been left uncontrolled in order to stimulate farm production, but the President has acknowledged that a new system of export controls may be needed over the short-run to ensure adequate supplies at reasonable prices for the domestic market.

Washington's Future

Now, how will all of this affect Washington's future over the next several years? The general implications are fairly obvious. We all realize, of course, that your regional economy will be affected if foreign food stocks run low, or if businessmen cut down on their airline travel, or if Detroit sells fewer cars, or if contractors put up fewer homes, and so on. But allow me to be more specific, even though you are familiar with many of these points, about the major influences affecting the state's near-term future.

Already we have seen some impact of the nationwide decline in housing starts, as the lumber industry has retreated from its feverish pace of 1972 and early 1973. Softwood-lumber prices jumped 24 percent and plywood prices soared 63 percent in the first four months of the Phase III period, but now prices have begun to retreat from those peaks. The price upsurge probably played some role in stabilizing the market, however, both by curbing demand and stimulating

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greater supplies. Further domestic supplies should come from the Administration's decision to increase the amount of timber offered for sale from Federal forests, and from the Japanese agreement to curtail their purchases of logs from Northwest forests. Nonetheless, supply problems may persist here for some time to come, and the same is true of the pulp-and-paper segment of the industry, which may find it difficult to mobilize the funds needed for capacity expansion at the same time it is paying for expensive pollution-control equipment.

The aerospace industry's backlog has been steadily expanding this year, and the future looks fairly strong because of industry projections of an 11-percent annual gain in domestic-airline traffic over the next decade. Indeed, Boeing is reported to believe that it could sell \$22 billion worth of planes by 1980 if the world market grows as anticipated and if it maintains its present share of that market. But we know full well that airline traffic -- and aircraft sales -- can fluctuate considerably over the short run, and it remains to be seen whether Boeing's coming 7X7 will have the spectacular success that its predecessor 727 model has turned out to be. Even so, the near term looks pretty solid, and some of the items on the company's long list of diversification programs (surface and hydrofoil transportation, computer services, electronic products, desalination, and so on) appear to informed observers to be very promising.

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Aluminum demand may taper off as consumers reduce their headlong pace of buying for new homes, new cars and other products, but the industry's basic short-term problem may prove to be one of supply. The present shortages are partly due to the regional industry's difficulties, with about 250,000 tons a year of capacity shut down since mid-April because of the hydro-power shortages you are all familiar with. But even when streamflows improve and power supplies are resumed, the national supply of aluminum could remain tight, since no new smelter capacity is scheduled to come on stream until 1976.

The state's farm economy also may have trouble in keeping up with the burgeoning demands of national and international markets. Washington farmers increased both their winter- and spring-wheat plantings, but the total crop may be not more than two-thirds as large as last year's because of freeze and drought losses. Even so, with the prices at the highest levels of the past quarter-century, wheat crop receipts may again reach record levels. Cattle receipts also should continue strong, since cattlemen can benefit from the very high levels of prices (reflecting the strength of income- and population-based demand) and from the record numbers of cattle being sent into feedlots.

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Altogether, the welcome deceleration which we foresee for the national economy should have no untoward effect on the regional economy. The slowdown, together with the 60-day price freeze, should relieve some of the severe price pressures which have distorted the lumber and metals markets, and should permit demand for the products of Washington's farms and factories to settle along a sustainable growth path. If troubles should arise, however, significant support can be expected from the development of the Jobs Now and Washington Future programs, with the former's emphasis on tax deferrals for factory construction, and the latter's emphasis on a broad-based public-works program, one of the largest in the state's history.

Financial Implications

I trust that you as bankers will handle the coming transition as well as you did the difficult downturn several years ago. As you undoubtedly remember, banks as a group performed quite well during the 1970-71 slump, with total deposits growing at a 10-percent annual rate, even faster than during the late 1960s. This influx of funds enabled banks to expand loan volume by 11 percent a year, only slightly below the earlier pace.

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Last year's general business expansion provided the basis for an even sharper increase in loans -- a 15-percent gain -- with a marked pickup in the business and consumer sectors. This loan upsurge of course has continued into 1973, reflecting the myriad financing requirements of the manufacturing, trade and service industries in an expanding economy, along with mortgage and consumer-credit demands as well.

In coming years, I expect that your role will encompass not only your usual support of Washington's traditional industries, but also some innovative financing in new fields essential to future growth. I am thinking specifically of such areas as pollution control and nuclear power, along with expanded international trade. Already, in this latter area, your financial and advisory services have been enhanced through overseas operations established under Edge Act authority -- through joint ventures, representative offices and branches. Further developments may occur under the reciprocity provisions of the recently-enacted Alien Bank bill, which permits non-U.S. banks to operate either a full-service branch or an agency office in Washington on a reciprocal basis.

The immediate challenge, however -- and it is a pressing one -- is to join with us in a cooperative effort to bring the present inflationary boom under control. All the weapons

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of official policy are gradually being brought to bear on this problem. Fiscal policy, although far too belatedly, is finally moving the Federal budget in the direction of a smaller deficit, thereby providing less stimulus to the boom. Monetary policy has attempted to curb excessive credit expansion through open-market operations, through marginal reserve requirements on CD's and other instruments, and now through the highest discount rate in the last half-century. But in the last analysis, it is you that must discipline the rate of loan expansion, especially business loans, in such a way that only the essential needs of the business community are financed. I urge you to see that this is done, as an important contribution to the fight against inflation.

Summary and Conclusions

To sum up, we have witnessed in the last two years a remarkable recovery in the state's economy, with the major "export" industries -- first farming and forest products, then aerospace and aluminum -- responding to the revival of demand for their products in national and international markets. Today, however, these crucial industries are faced with the task of adjusting to a deceleration in the national economy. In addition, each of them faces its own

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unique set of problems, with (for example) the lumber industry forced to deal with an actual decline in housing starts and the farm sector still confronting a strong worldwide demand for food.

The unusual severity of the 1969-71 recession reflected a bunching of individual recessions in several key industries, but it also reflected the over-optimism implicit in the expansion plans formulated during the previous boom. In the present recovery, producers apparently are not making the same mistakes, but rather are gearing capacity more closely to demand. In this situation, the banking community has a role to play in ensuring that the expansion is kept within bounds, and that the mistakes made during that earlier boom are not repeated.

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