THE ECONOMIC OUTLOOK AT MID-YEAR -- CALIFORNIA AND THE NATION

Remarks by

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at

Los Angeles Chamber of Commerce
Mid-Year Business Outlook Forum
Los Angeles, California

July 24, 1973

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I welcome the opportunity to participate in today's Business Outlook Forum, particularly because of the very propitious timing of this event. Perched as we are on the top of a business boom, all of us should welcome any insights we can get into the future course of this spectacular boom. At the same time, none of us should underestimate the difficulties of economic forecasting at this stage of the business cycle.

The problems involved in predicting the future trends of the national economy can be compounded by attempting to apply that forecast to the regional level, especially in the case of California, whose economic profile differs in so many ways from the national average. Nonetheless, I shall attempt that task here today, knowing full well the difficulties involved, and touching only indirectly on the equally interesting question of how California has been able to recover so well from its earlier recession.

Where We Stand

The crucial aerospace sector has gained back only a fraction of the more than 150,000 jobs lost during the slump at the turn of the decade. In addition, the state has witnessed the near-disappearance of a traditionally important growth factor -- a net inflow of migrants amounting at the peak to 1,000 a day. Yet, despite these growth-inhibiting developments, California over the past year and a half has grown somewhat faster than the nation as a whole. California's labor force has increased very rapidly over that period, but so has the total number of jobs. As a result, the unemployment rate here is now close to the national average, after a period of years in which it was as much as a full percentage point higher.

California's cyclical recovery has been broadly based, with employment expanding faster than elsewhere in almost every major sector of the economy. This phenomenon was especially noticeable in the quarter just ended, with the machinery, furniture, apparel and transportation-equipment industries all growing at a faster-than-national pace. Altogether, the recent performance has been very impressive, based as it has been on the strong national and international market for California's diverse agricultural and industrial products. In banking, meanwhile, business loans increased at a 29-percent annual rate in the first half of this year, an unparalleled growth, and other loan categories rose at a 21-percent rate, outpacing the growth record of banks elsewhere in the nation.

The dimensions of the nationwide boom also can be briefly stated. The first-quarter gain in GNP was one of the largest on record -- $43 billion, or a 15-percent annual rate of increase. After allowance for price increases, the gain was still 8 percent, exceeding the strong 1972 gain and almost double the rate which economists consider sustainable over the long-run.

Then, in the second quarter, the hectic pace of expansion moderated: GNP increased about $29 billion, for a 9 1/2 percent annual rate of increase in dollar terms and only a 2 1/2 percent rate in real terms. But this slowdown can be attributed mostly to the fact that the reserves of usable industrial capacity and experienced manpower were stretched dangerously thin by mid-year.

Because of the intense capital-goods boom, industry has found it impossible to work off its order backlogs, which for durable goods are now 29 percent above the year-ago level. As for the unemployment rate, it did not fall below 5 percent until June; but for married men, the rate had already dropped below 2 1/2 percent, reflecting the severe shortage of experienced workers.

All these pressures have resulted in an unprecedented price upsurge. The GNP price index rose at an annual rate of about 6 1/2 percent during the first half of the year -- more than twice the 1972 pace -- and consumer prices rose at about an 8-percent rate during the same period, largely because of the phenomenal jump in food prices. Equally worrisome, however, has been the rise in wholesale industrial-commodity prices. These increased at a 15-percent annual rate from the inception of Phase III in January to the advent of Freeze II in June.

Where We Are Heading

The question thus arises: can we slow down the boom to a more sustainable and less inflationary pace without at the same time pushing the economy into recession? There is a substantial danger that we cannot, since the business-cycle history of the past generation suggests that the U.S. economy is unable to make the transition from inflationary boom to noninflationary growth without an intervening recession. I am not saying that a recession is now inevitable, but I am saying that our chances of avoiding one are rather slim unless we pursue correct anti-cyclical policies today.

Having made that crucial assumption, however, my economic research staff has concluded that there is a reasonably good chance of avoiding the worst. Their forecast shows GNP rising from $1,155 billion in 1972 to about $1,285 billion in 1973 and (very tentatively) to about $1,380 billion in 1974. More importantly, the forecast indicates that the economy will decelerate in real as well as in money terms, with the real rate of growth falling from a peak 5 1/2-percent rate in the first half of 1973 to a 3 1/2-percent rate in the current half-year, and then to about 3 percent in 1974. With inflationary pressures subsiding, the upsurge in the GNP price index should taper off, following a 6 1/2-percent annual rate of increase in the first half of this year. The research staff projects GNP price increases of about 5 percent in the second half of 1973 and 4 1/2-percent in 1974.

Several different sectors will be responsible for the relative slowdown in activity. Residential construction, the main support of the early stages of the boom, is likely to show an actual decline, both in dollar terms and in the number of housing starts. The number of starts could decline from 2.4 million in 1972 to 2.1 million in 1973, and 1.8 million in 1974. The decline can be blamed upon rising construction and mortgage costs, as well as a reaction from the earlier overbuilding by some contractors. Also, with the housing sector declining, purchases of furniture and appliances are likely to moderate from their recent heavy pace.

Auto spending similarly should decelerate, partly because of the unsustainable sales pace of recent quarters and partly because of the heavy burden of debt now overhanging consumers. By year-end, considerably more than one-fourth of all the 100 million cars on the road will be less than three years old. As a result, the replacement rate should decline and contribute to some weakening of sales over the next year or so.

Other sectors, although decelerating, should register respectable increases in dollar terms -- for example, government spending, consumer spending except for durables, and in particular, business fixed-investment spending. Actual spending for plant and equipment has recently trailed spending plans and appropriations, because of bottlenecks and delays of various types, and order backlogs for capital goods consequently have expanded. Because of this catch-up factor, capital-goods spending will probably continue high even if some easing of sales occurs at the retail level.

The nation's farmers, who for a change are flush with cash, are likely to increase their spending substantially, both for consumer goods and capital equipment. In addition, export demand should remain very high, because of both the continued food shortages overseas and the bargain-basement prices for American goods available as a result of the several devaluations of the dollar.

The California Outlook

All of the factors just cited will affect California over the next year or so, although to varying degrees depending on their impact on the state's major industries. Cash farm receipts are almost certain to rise very substantially this year and -- despite the ever-rising trend of production expenses -- net farm income should reach new peaks this year and perhaps next year as well. Cash receipts will rise because of the very high price levels for cattle and calves, and because of the substantial crop expansion induced by rising domestic and export demands.

The aerospace industry, which accounts for 30 percent of the state's manufacturing jobs, is likely to play a neutral role, with little change in employment over the next year or so. (This contrasts with its crucial role in both the Vietnam boom and the subsequent bust.) The commercial market looks promising because of the demand for aircraft by foreign airlines and the expected growth of the domestic electronic-equipment market, but an offsetting factor will be the completion of work on Skylab and other government projects. As we move into the new fiscal year, much will depend on Congressional feelings about certain key Administration projects, such as the space shuttle, the B1A bomber and the Trident submarine-launched ballistic missile.

The housing sector is likely to be a drag on the regional economy, and for the same reasons that I have cited in discussing the national industry. Somewhat to the experts' surprise, the level of housing permits so far this year has been fairly close to the 1972 average rate of 280,000 units, but the pace has moderated recently and a significant decline can be expected in coming quarters.

The unexpected strength in housing may be due less to basic demand factors, which have been weakening, than to the desire to hedge against rapidly rising construction costs and widening environmental restraints. Whatever the factors involved, we expect that an easing of demand and tighter money will bring about a housing downturn, and that this will be accompanied by a weakening trend for housing-related items, such as furniture and appliances.

In other construction, a growing oversupply of office space in some local markets should hold down planning for new office buildings, but factory building should surge ahead in line with the nationwide plant-equipment spending boom. That development in turn should support a heavy demand for California-produced steel, which already has gained a stronger hold over its own local market because of the impact of devaluation on the price of foreign steel.

In general, California presents roughly the same picture as the nation -- an economy bursting at the seams, but one that is likely to slowdown gradually over the next year. Measured in terms of personal income -- the broadest measure of regional growth -- the economy should expand from about $102 billion in 1972 to almost $112 billion in 1973, before rising to $119 billion or more next year. Employment should continue to expand over a broad range of sectors, and as a consequence, some further reduction in unemployment may occur, at least through the end of this year.

The Policy Outlook

This situation presents policymakers with some difficult problems. The most crucial question, of course, is how to bring the economy back to a sustainable growth path and reduce the unacceptable rate of inflation which now besets us.

Phase IV controls have a role to play here, by limiting wage and price increases until broader policy restraints can take hold. As that statement suggests, however, controls are only a stopgap, and cannot take the place of a coordinated program of monetary and fiscal measures.

The Federal budget will be less expansionary over the coming year as it moves towards balance. But this action comes too little and too late. As a matter of fact, the legislators in Sacramento have something to teach their colleagues in Washington, since they are carrying over a surplus of more than $800 million from fiscal 1973. In striking contrast, the Federal budget picture has been highly perverse, with fiscal 1973's $18-billion deficit stimulating rather than curbing the inflationary economy, and in the process, heaping huge demands on the credit markets, pushing up the level of interest rates, and tending to overstimulate the rate of monetary expansion.

The situation admittedly could have been worse, because the official budget figures last January indicated a $25-billion deficit for the fiscal year. Even so, the relative improvement since then cannot be attributed to any conscious policy decision, but rather to the impact of rising prices, incomes and profits on tax collections. The Administration and Congress deserve credit for holding expenditures below the $250-billion target, but they have been widely criticized for not having moved much faster in the direction of budgetary restraint -- through tax increases, if necessary.

Certainly Congress is not lacking for suggestions for ways of using the Federal budget as a better weapon of counter-cyclical policy. Federal Reserve Chairman Arthur Burns advanced three specific proposals of this type in Congressional testimony just several weeks ago. One proposal, which could have ecological as well as economic benefits, would be a tax on autos based on horsepower. Another would be the lowering of the 7-percent investment tax credit as a means of curbing the business spending boom. In addition, Chairman Burns proposed a compulsory savings plan, that would force corporations in inflationary times to turn over a certain proportion of their profits to a Federal Reserve escrow account, and that would then provide for a return flow of funds in less buoyant times.

All these measures, designed as they are to smooth the extremes of the business cycle, would have been extremely useful if they had been in effect this past year. In their absence, however, continued stress has had to be placed upon the weapons of monetary policy. In its initial attempts to counter the inflationary boom, the Federal Reserve tightened open-market policy early last winter, and thereby limited the supply of bank reserves in relation to swelling credit demands. These actions were supplemented in mid-May when the System turned its attention to the increasing commercial-bank reliance on money-market sources of funds, by imposing a supplementary 3-percent reserve requirement on large CD's and related instruments in excess of those held in the mid-May base period.

Then, late last month, the Federal Reserve moved up its heavier artillery, with an across-the-board increase in reserve requirements on member-bank demand deposits. By raising reserve requirements one-half percentage point -- for example, from 17 1/2 to 18 percent for the largest banks -- the System required an addition of about $800 million to the reserves supporting the loan and deposit structure of the banking system.

The Federal reserve also raised its discount rate for the sixth time this year, so that it now stands at 7 percent -- a figure matched only during the tight-money period of 1920-21. This action reinforces open-market policy by discouraging the further borrowing of reserves. (Borrowings during the spring months were about three times the level of last fall and considerably above the 1969 peak.) Instead, the higher discount rate encourages banks to adopt a more cautious lending policy and thereby helps to reduce the further expansion of credit. Finally, the monetary authorities raised the ceiling on interest rates that banks and thrift institutions may pay on passbook savings and other consumer accounts, partly to provide consumers with a greater measure of equity in the present environment of rising interest rates, but more importantly, to minimize the risk of savings outflows and guard against the shrinkage of the supply of mortgage funds.

Throughout this period of tightening credit, the Federal Reserve has acted to forestall a repetition of a credit crunch of the 1966 or 1969-70 variety, when many borrowers suddenly found funds to be unavailable at any price. To keep funds available, the authorities have used such techniques as the raising of rate ceilings on consumer savings and the complete suspension of ceilings on large CD's. Consequently, the credit needs of the expanding economy have been met, although at a higher price.

Summary and Conclusions

To sum up, California and the nation are now involved in an inflationary boom which could deteriorate into recession, as has happened so often in the past. With proper policy measures, however--and with a modicum of luck--we will avoid the worst and will slow down the boom to nothing worse than a temporary period of subnormal growth as we move into 1974. Business fixed-investment spending should remain high as businessmen strive to add new capacity to meet the future needs of the national economy, but the pressure from that source should moderate over time as consumer buying slows and as housing spending actually declines. The California economy will be affected by all of these conflicting factors, but also by special factors of its own -- on the one hand, by the heavy worldwide demand for California farm products, and on the other, by the still modest level of activity in the key aerospace-manufacturing industry.

With the development of Phase IV controls and the gradual improvement in the nation's fiscal position, a balanced set of policy measures hopefully will be set in place to govern the 1974 economy. The Federal Reserve, having supported the recovery from the earlier recession, now stands ready to support an ongoing expansion in line with the long-term growth trend of the national economy. To do so, however, it needs the cooperation of all members of the banking community, in line with Chairman Burns' request that the rate of bank-credit extension be "appropriately disciplined". Similarly, it needs the support of all members of the general business community, who from their own self-interest should postpone marginal expansion projects until the time when the scramble for resources becomes less hectic. I am sure that all of you will see the wisdom of such a course.

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