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PROBLEMS AND POLICIES IN 1978

Remarks of

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Problems and Policies in 1978

I'm delighted to be here again in the Crossroads of the Pacific. I'll be spending the next several weeks visiting four Far Eastern countries, discussing problems of common interest with a number of government officials and commercial bankers. I'm also grateful, however, for the opportunity to stop first here in Hawaii, to spend some time with present as well as potential member banks. But being a California chauvinist, I'm not sure that I'll stop for a wine-tasting tour at the winery that's been operating on Maui recently.

In preparing for my tour, I've become strongly impressed with the interrelated nature of the economies of the world's major trading countries. Indeed, my remarks today about the U.S. economy also reflect the major impact which foreign countries are having upon our nation's future prospects. But none of this is news to the people who live here in Hawaii. Now more than ever, Hawaii's future depends on the events occurring on the Mainland, in Japan, and in many other countries as well.

Factors Influencing Hawaii's Economy

Most analysts of the local economy expect personal income in Hawaii to increase 10 percent this year, to about $7.4 billion. Still, a great deal depends upon such factors as the number of visitors and the amount they spend here. You can count on 17,000 bankers in October and 28,000 realtors in November, not to mention all of the nation's top volleyball players, but the shape of the economy elsewhere will determine whether you get 3 million more visitors from the Mainland and 660,000 visitors from Japan, as your planners here seem to expect. Actually, those figures may be conservative, considering the substantial amount of buying power in the hands of potential U.S. visitors, or the very strong price advantage that Hawaiian vacations now offer to Japanese tourists.

Outside influences will affect the health of other key Hawaiian industries, such as sugar. The price-support program, which assures sugar producers at least 13½ cents a pound for their product, may create somewhat optimistic expectations for the state's largest agricultural industry. But longer-term prospects are bound to be affected also by the surplus of sugar in world markets and the failure of the new International Sugar Agreement to stabilize the situation. Again, in the construction industry, the strength of the upturn from the relatively weak performance of the past several years undoubtedly will depend on such factors as the state of the national mortgage market, which has come under pressure in recent months because of rising credit demands and rising interest rates. And of course there is that major questionmark--can labor peace be achieved on the docks this year, without the type of disruption suffered during the prolonged strike of six years ago?

I'm generally optimistic on all of these points, but I think it wise that we keep always in mind the extent to which outside forces determine the prosperity of the economy in which we operate. The same is increasingly true of the national economy, as I hope to demonstrate later on. But first, let me take a minute to summarize what's been happening on the Mainland, and what the broad shape of the future looks like there.

Outline of 1978 Growth

First of all, the national economy has behaved remarkably well the past several years, bouncing back from both the worst recession and the worst inflation of the past generation. Over this period, the $2-trillion economy generated one of the strongest and most prolonged expansions of the past several decades. Last year, for example, total production of goods and services increased almost 5 percent in real terms, and this second straight larger-than-normal increase brought into play more of the reserves of labor and capital that had been left unemployed by the 1974-75 recession. The jobless rate dropped sharply to the lowest level of the past three years. Again, employment increased faster than at any time since World War II--up more than 4 million over the year--and a record 58 percent of the working-age population held jobs at year-end. But at the same time, a persistent inflation constantly threatened to undermine this expansion and to aggravate our many domestic and international problems.

We may see the same type of numbers in 1978, judging from the forecasts made by my staff economists and various other forecasters. Total real output may increase about 4½ percent above its 1977 average. Thus, the economy would still be growing above its long-run potential, calculated in terms of a steadily expanding and more efficient workforce. The pattern of business activity meanwhile may shift considerably over the year. Output suffered considerably during the first quarter because of severe winter weather and a prolonged coal strike, but a sharp recovery is almost certain this spring as business firms rush to replenish their stocks, while a more moderate pace may develop later this year. The pace of business activity thus may be sharply influenced by the pace of inventory spending, repeating much of what we've seen the past several years. Businessmen generally have been reluctant to hold large inventories, and this has caused sudden depletions of stocks whenever sudden shifts developed in supply or demand--followed shortly thereafter by flurries of stockroom activity. We saw that pattern last year, and may see a repetition this year, although with some difference in timing.

We should also witness a mixed pattern of spending in other sectors besides inventories. Consumer auto demand obviously has already weakened, partly because of buyers' disinterest in scaled-down models with scaled-up sticker prices. Also, single-family home construction could retreat from its record 1977 pace, as mortgage-lending institutions adjust to the recent slowdown in savings flows. Business spending for plant and equipment may remain a question mark; projected spending plans reflect a great deal of caution on the part of corporate planners, yet some indicators, such as construction contract awards, look quite strong. Meanwhile, spending by state and local governments should grow, bolstered by Federal grants and by the expanding economy's boost to tax revenues. Again, defense spending seems more expansive, judging from the new budget estimates and from the strong trend of new orders for defense products. From all of this, we might expect continued growth but a change in the character of the expansion--that is, a slowdown by the fast-growing sectors of 1977 (such as autos and housing) but a speed-up by some of the former slow-growing sectors (such as defense spending and state-local government outlays).

Because of this scenario of moderate growth, most forecasters had predicted earlier that the unemployment rate would drop to about 6½ percent of the labor force sometime in 1978. Well, we were significantly below that rate in the first several months of the year, and there's a strong possibility that the jobless rate will fall below 6 percent later in the year. Of course, to some observers that still represents a substantial amount of slack in the economy. But they are probably wrong, because the published jobless rate is a much poorer guide than it used to be, largely because of a number of shifts in our population mix. The pressures already reached in the labor market can be measured by the fact that the volume of help-wanted advertising jumped one-third over the course of the past year--and that a record 58 percent of the working-age population now holds jobs. In fact, my economists argue that we're already very close to the point of full employment--that is, the point at which further stimulus to the economy will only generate more inflation without making any dent in the problem of unemployment among unskilled workers.

Inflation--Domestic and International

The greatest danger to the continuing recovery could be a resurgence of inflation. Compared to a few years ago, we're doing quite well, because the inflation rate was cut in half between late-1974 and early-1976. But we've made no real progress over the past two years, and in fact there was some reacceleration of inflation in 1977 and early 1978. Most analysts now agree that a 6-percent rate of inflation has become imbedded in the overall economy, judging either from the past year's trend of prices, or the increase in wage costs incurred by major pattern-setting industries, or the amount of past fiscal and monetary stimulus. Moreover, we might see further price pressures from a depreciating dollar, reflecting the much higher costs of goods from Japan, Germany and other trading partners.

The recent steep decline in the value of the dollar was a shock to most people, and there's still a great deal of disagreement concerning the causes of the problem. Some people blame the shift in our merchandise-trade balance, which went from a $9-billion surplus in 1975 to a $31-billion deficit in 1977. For one reason, oil imports shot up 75 percent between 1975 and 1977, because we didn't produce enough in this country and instead purchased more and more from the OPEC nations. For another reason, imports of other products increased 48 percent above the 1975 figure, because of the strong expansion of our domestic economy. And for yet another reason, U.S. exports rose only 14 percent above 1975, because of the sluggish growth of most overseas economies.

We must remember, however, that the large U.S. trade deficit was not the only or even the major factor in the steep decline of the dollar. When we had a large trade surplus in 1975, the value of the dollar was even lower than now, whereas in the opposite circumstances of 1976 and early 1977, the value of the dollar actually increased. Throughout that recent period the trade imbalance was offset by a very substantial capital inflow, explainable in terms of the high degree of foreign confidence in our political and economic stability--including our price stability. But in late 1977, many of those foreigners suddenly lost their confidence in us, and decided to get out of dollars. From late September on, the dollar declined steeply and steadily against almost all major currencies except the Canadian dollar--11 percent against the German mark, the Japanese yen, and the British pound, and even more against the Swiss franc. The market then stabilized in early January, when the Federal Reserve and the Treasury undertook support operations in the market and the Fed underscored this move with a half-point rise in its discount rate.

But why did market expectations turn so suddenly and steeply against the dollar? Perhaps because market participants feared that the trend of inflation was worsening here compared to other major countries. After all, there was the evidence of the several bulges which developed in the U.S. money supply in 1977, which to many observers represented a loosening of monetary policy and therefore an unleasing of price pressures. Monetary growth accelerated in the U.S. between 1974-75 and the subsequent two-year period, contrary to various other major countries. Also, our price performance last year was worse than in the year before, contrary to various other major countries. Consequently, market sentiment turned against the dollar. And once again the dollar showed that it is especially sensitive to changes in inflation expectations, because its usefulness as an international store of value and medium of exchange depends heavily on its stability and negotiability.

We can see the elements of a solution simply by citing the causes of the dollar problem. But since the basic cure--curbing inflation--at times seems so unattainable, the experts try to develop secondary strategies as a means at least of ameliorating the disease. One such solution would be the government's issuance of foreign-currency denominated securities. For example, if the U.S. government issued Deutschemark-denominated securities, it would remove an important transitory pressure from the foreign-exchange market. At present, people who wish to move out of dollars into Deutschemarks have to do so by selling dollars and buying Deutschemarks in the foreign-exchange market. This tends to drive the exchange value of the Deutschemark up, so that some German exporters and importers come to be priced out of the market. These firms therefore adopt a protectionist stance, which could lead to a reversal of the 30-year trend toward freer trade. But if the U.S. Treasury sold DM-denominated securities, it would allow investors to shift their portfolio out of dollars into Deutschemarks directly without causing a major impact on the exchange rate. Under this approach, exchange rates would not have to adjust as much to accommodate shifts in asset demands for dollars, and thus would be able to move more in line with the relative commodity value of the dollar. But basically, this type of action would do nothing to correct the fundamentals that have caused the dollar's problems, such as the trade deficit and (especially) inflationary expectations. So once again, we're faced with the basic prescription of curbing inflation if we are to solve either our foreign or domestic problems.

Financial Market Developments

Let's consider the situation in domestic financial markets, which have performed so well these past several years. In 1977, for example, commercial-bank credit expanded by a record $82 billion, exceeding even the exuberant performance of 1973--and almost all of the growth was in loans. In 1978, loan demand should continue strong but perhaps shift into different channels, with less emphasis on the mortgage and consumer sectors and more emphasis on corporate borrowing.

Financial markets last year generally exhibited the same strength visible in bank-lending activity, although at a rising level of short-term interest rates. These rates increased about two full percentage points during the year, reflecting the growth of business activity and the firming of monetary policy which followed in the wake of the several spurts in money-supply growth. Still, long-term rates increased only slightly in 1977, despite the heavy volume of financing in the capital markets, before rising noticeably in early 1978. This leads to the key question--can a strong business expansion continue in 1978 without significant upward pressures on rates? The answer depends in large part on the markets' view of how well the fight against inflation is being waged.

Too few people clearly understand the long-term effects of price expectations on interest rates, and the way in which such expectations can offset other market influences. But the basic point is quite clear. With prices expected to rise at (say) 6 percent a year, lenders will demand a 6-percent inflation premium plus some basic "real" rate of interest, to protect themselves against an expected loss in the purchasing power of their money. But borrowers will be willing to pay this inflation premium, because they expect to repay their loans with dollars that are worth (say) 6 percent less each year than the dollars they originally borrowed.

Policy Problems

Curbing inflation expectations thus is a must if we are to solve our domestic as well as our international financial problems. But this means that we must get at the basic causes of inflation. Luckily, we're not likely to see again the unusual combination of circumstances that made the 1973-74 inflation so severe--the worldwide industrial boom, the worldwide crop shortages, and of course the OPEC oil-price upsurge. But we must still contend with long-term price pressures, especially the major pressures arising from continued large-scale Federal deficit financing.

At this mature stage of the business expansion, Congress and the Administration face some difficult fiscal choices. A substantial tax cut may be necessary to maintain economic momentum, considering the drag imposed by $40 billion or more of tax increases--the social-security tax hike, the projected package of energy taxes, and especially the severe "tax" imposed when inflation pushes people into higher tax bracket. At the same time, a substantial reduction seems necessary in the combined Federal budget deficit of $114 billion projected for the 1978-79 fiscal years, considering the pressures on the Federal Reserve to finance such deficits through excessive monetary expansion.

Over the past decade, deficit spending frequently worked to pull monetary policy off course in an expansionary direction, by supporting excessive growth of money and credit. This happened because interest rates generally rose whenever large-scale Federal borrowing was piled on top of expanding private-credit demands. Higher rates then undermined the strength of certain sectors of the economy which are especially vulnerable to the high cost of credit, such as housing, agriculture, and small business. Under pressure to minimize this type of impact, the Federal Reserve sometimes delayed taking firm action to head off excessive growth of money and credit, and the eventual result was more inflation.

Accordingly, while Congress and the Administration face some difficult fiscal choices at this stage of the expansion, the Federal Reserve for its part faces some difficult monetary-policy choices. If prices should accelerate, and if the Fed should move aggressively to tighten credit, "crowding out" might become a reality rather than only a distant threat to the financial market. In that case, Treasury financing demands could dominate the market and deny credit to the vulnerable industries I just mentioned. Alternatively, if the Fed should try to accommodate all credit demands in this inflationary atmosphere, the result might be another excessive bulge in the money supply and a further boost in inflation expectations--setting the stage for another possible cycle of economic instability. And now that we've received a warning from the foreign-exchange market, any resurgence of domestic inflation could lead to a severe and lasting deterioration in the value of the dollar--which in turn could give another push to the vicious spiral of inflation.

To avoid just such a scenario, monetary policymakers today are striving for a gradual reduction in the growth ranges of the monetary aggregates, to a level consistent with long-run price stability. In his initial appearance before the House Banking Committee last month, Chairman Miller reported the Federal Reserve's intention to stick with the lowered growth ranges for the monetary aggregates adopted last year--4 to 6½ percent annually for M_1 and 6½ to 9 percent for M_2. (M_1 equals currency plus bank demand deposits, and M_2 equals currency plus all bank deposits except large CD's.) The actual figures for 1977 were on the high side in relation to the target ranges set the year before, but the performance in this regard has improved considerably since last fall. Yet given the fiscal and economic environment that I've described, further progress towards the Fed's long-term goal could at times be difficult in the year ahead.

Concluding Remarks

To sum up, we seem to be moving into a year that holds considerable promise, providing that we keep a good grip on the reins guiding our $2-trillion economy. Admittedly, the expansion is now about three years old, which brings it into the realm of middle age. But we should remember that business expansions don't just die because of old age, but rather because of riotous living during their earlier stages. In the present context, that means we must bring the economy down off its inflation high by administering the right fiscal and monetary-policy medicine -- that is, through a slow but certain reduction of fiscal deficits and monetary growth.

To accomplish our goals, we must maintain a large measure of discipline in our fiscal and monetary policymaking. Among other things, that requires maintaining the independence of the Federal Reserve within the structure of the Federal government. Over the decades, we in the Fed have been able to make prompt and (if need be) frequent changes in monetary policy, in contrast to the necessarily ponderous processes of fiscal policy. We've also been able to make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. A number of such decisions may have to be made in the years ahead, but that is the price required for sustaining a period of domestic and international prosperity into the 1980's.

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