FRB-SF
FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

FIGHTING INFLATION

Remarks of
John J. Balles, President
Federal Reserve Bank of San Francisco

Meeting with Salem Community Leaders
and Board of Directors, Portland Branch,
Federal Reserve Bank of San Francisco

Salem, Oregon
June 1, 1978

Fighting Inflation

I'm happy to have this chance to visit one of our nation's true garden spots, to rub elbows with Governor Straub and the other leaders of Oregon's capital city. I am especially pleased that I can meet with you today under the sponsorship of the Board of Directors of our Portland office -- an extremely able and diverse group of individuals.

I'd like to bring to your attention today the need to make an all-out fight on inflation, especially in view of the way that inflation undermines the national housing industry, and thereby Oregon's key lumber industry. But before I begin, I would like to spend a few moments reviewing the important role performed by directors of a Federal Reserve Bank, which is unique among the central banks of the world. Only in the United States does the nation's central bank benefit from a "grass-roots" input to policy. Our directors are concerned with each of the four major jobs delegated by Congress to the Federal Reserve -- that is, provision of "wholesale" banking services such as coin, currency and check processing; supervision and regulation of a large share of the nation's banking system; administration of consumer-protection laws; and above all, the development of monetary policy. We are fortunate in the advice we get from our directors in each of these four areas.

The value of their advice is given greater weight by the diversity of the occupations and groups which they represent. We have consistently obtained the services of a wide range of very competent businessmen, bankers, academicians and agriculturists. But in addition, I'm proud of the fact that, among our five offices, our District has been the first in the Federal

Reserve System to appoint a woman director, a Black director, an Asian-American, and a Latin-American to these key positions. In Ken Smith's case, I recently found that another Reserve Bank had preceded us in appointing a Native-American director -- so Ken, with his many other distinctions, will have to be known as the second Native-American Fed director.

Scope of Directors' Advice

Let me give some examples of the ways in which the directors help us evaluate and form recommendations on important policy issues, especially those concerning the problem of inflation. On one recent occasion, Dr. Jean Mater suggested that we look into the inflationary cost increases associated with anti-pollution legislation. This led to the preparation of an article on that subject by one of my staff members, David Condon, in our Winter 1978 Economic Review. He pointed not only to the dollar costs of pollution-control equipment, but in particular to the costly delays resulting from uncertainty and the permit process, which tend to reduce new capital spending and thereby create inflationary bottlenecks.

Again, Stub Stewart suggested that we look into the inflationary cost increases for the housing industry associated with below-optimal cutting of timber in the National Forests. (I understand that Governor Straub has discussed this matter with President Carter; in fact, everyone in Oregon seems to have discussed this problem with the people in Washington.) This suggestion led to the preparation of an article by Yvonne Levy in the same issue of our Economic Review, and to a full-scale presentation by the author before the Portland Chamber of Commerce several weeks ago. Mrs. Levy pointed out that the National Forest Service's present harvest policy fails to meet economic-efficiency criteria -- that we need a more flexible harvest strategy, better tailored to meet the requirements of the market, to alleviate upward pressures on forest-product prices.

Our directors provide us not only with advice on policy issues, but also with a constant flow of information on an area which is a key supplier to both the national and the international economies. Thanks to them, we realize now what a major role Oregon plays in the Sun Belt -- a name which I assume applies to the business climate rather than the meteorological climate. Among the larger states, Oregon stood fifth in the nation in terms of population growth over the 1970-77 period. That 13.6-percent population increase thus has laid the foundations for a broad and diversified economy, and has reduced the state's dependence on the nation's volatile housing industry. In typical Sun Belt fashion, Oregon's employment last year alone increased by 8 percent -- more than double the strong increase recorded elsewhere. And despite some signs of weakness in the national housing picture, Oregon's economy should benefit this year from other important developments -- such as the nationwide upturn in nonresidential-building activity, the turnaround in the cattle market, the improvement in crop prospects because of the end of the drought, and the improvement in export prospects because of the depreciation of the dollar.

State of the Economy

But now, since Oregon depends so heavily on national trends, let's consider what's going on in the U.S. economy. First the good news -- a little-recognized piece of good news, by the way. The $2-trillion national economy is still in the midst of the strongest and the longest peacetime expansion of the past quarter-century. The Korean War expansion was somewhat stronger, and the Vietnam War expansion of the 1960's was somewhat longer. But no other expansion of the past generation could match the economy's recent performance -- an ability to churn out the yardage, quarter after quarter, ever since the dismal days of early 1975. The expansion has proceeded at a healthy 5.2-percent annual growth rate over that three-year period, and only two of the quarters in that period have been substandard in growth -- including the weather-affected first quarter of 1978.

Many experts have seriously underestimated the strength of this expansion. One reason may be because time was needed to offset the preceding recession -- the sharpest and steepest downturn of the past generation. Another reason may be because of the continued high level of reported unemployment. However, we have created almost 10 million new jobs in this three-year-old business expansion -- about as many as in the preceding eight years put together. Indeed, the economy now seems to be effectively fully employed. Scarcities of trained workers are developing, the index of help-wanted advertising is at least a third higher than a year ago, and the jobless rate among household heads is down to 3.7 percent. Admittedly, there is a serious unemployment problem among some groups, such as black teenagers. But those individuals can find employment only if we develop better training programs or create more low-wage entry-level jobs -- and not if we overheat the economy through shotgun-type programs of economic stimulus.

At this stage, the big question is whether the expansion can continue, or whether it will drift into recession. On balance we could expect some deceleration in activity, because of the strains beginning to show up in the economy, but we should still be able to avoid recession. Housing and autos, the sparkplugs of the earlier stages of the recovery, have again strengthened in recent months. Still, they may weaken later, partly because of the heavy load of debt assumed by consumers over the past several years. Meanwhile, we are seeing a speed-up in activity by some of the former slow-growing sectors of the economy. Spending by state and local governments should accelerate, bolstered by Federal grants and by the expanding economy's boost to tax revenues. Defense spending may become more expansive, as indicated by the growth of military prime-contract awards, which are running sharply above a year ago.

The prospects for this expansion, and for much else besides, depend heavily on what occurs in business plant-and-equipment spending. At long last, we're beginning to get some optimistic signals from this sector. Indeed, the latest spending surveys suggest a definite turn in sentiment. Moreover, the leading series for business capital investment -- capital-goods orders and construction-contract awards -- both indicate a significant upturn in this key sector of the economy.

Inflation Problem

Altogether, there still seems to be considerable life left in the business expansion. But now let's turn to the bad news -- the upsurge in prices. Indeed, the relatively optimistic outlook for the economy could be undermined by a worsening of inflationary expectations among consumers and business people. Hence, I want to stress today the vital need to come to grips with the inflation problem.

The President's Economic Report early in the year said that an inflation rate of about 6 percent had become imbedded in the economy. Unfortunately, events seem to have overtaken even that dismal statistic. Food prices, always highly visible, increased at a 16-percent annual rate during the first quarter of the year. Consumer prices exclusive of the volatile food and energy components -- that is, items accounting for three-fourths of the entire consumer market basket -- rose at an 8-percent rate during the winter months, in contrast to their much lower 5-percent rate of increase during the second half of 1977. Then in April, wholesale prices rose sharply, while the closely watched monthly survey of corporate purchasing agents showed a very sharp increase in the number who reported paying higher prices. Everyone is now paying more for steel -- that basic metal underpinning our entire economy -- and everyone is now paying more for other essential materials. On the inflation front at least, Murphy's Law seems to have taken over.

Well, what are we going to do about it? If we believe in the old definition that inflation means too much money chasing too few goods, we can see the necessity for a double-pronged attack. First, let's consider how we can overcome bottlenecks and provide more goods to the economy. I've already mentioned some of the proposals our directors and staff have made about ways to overcome inflationary cost increases. And over the long run, we've got to find more ways of boosting the supply of products for households and business firms through improvements in efficiency. Steady increases in productivity, at a 2.2-percent annual rate over the past half-century or more, have brought us our present high standard of living, and further increases are necessary for providing us with the supplies we need today at stable prices.

Boosting Productivity

We can't take future productivity growth for granted. As I've suggested, there are lots of extra costs -- for environmental and safety legislation, for example -- which create substantial benefits but tend to lower productivity in the process. In the 1970's, the cost of such programs has been about one-fourth as large as the annual average productivity increase of the several preceding decades. But there are also some prospective plus signs in the productivity outlook. That famous baby-boom generation -- the one that we parents despaired of in the 1960's -- is now being magically transformed into a bumper crop of experienced and productive adults. To reach their full potential, however, they need lots of new capital equipment to work with.

Our future productivity growth -- which means our future standard of living -- thus depends on increased investment. And how do we stimulate growth in the nation's capital stock? First of all, through tax measures designed to enhance investment. We should reduce the corporate tax rate, as a means of boosting after-tax profits and thus providing business firms with more funds to invest. We should liberalize the investment-tax credit, specifically by extending the credit to business structures and not simply to short-lived assets. We should also extend that credit to research-and-development spending, because R&D provides us with the precious seed corn necessary for the productivity advances of future decades. But we also need a stable financial environment so that business firms will be willing to risk their funds -- which brings us back to the other (and more immediate) requirement for curbing inflation.

Curbing Deficit Spending

We must, above all, curb the excess creation of dollars. That means we must deal with the overstimulus achieved through massive Federal budget deficits, which in turn have created pressures on the Federal Reserve to ensure the financing of those deficits. Our recent worries, including the decline of the dollar overseas, can be traced in large part to the highly inflationary implications of a widening Federal deficit in the midst of a strong business expansion, from $45 billion in fiscal 1977 to $53 billion in fiscal 1978. And despite the reduction and postponement of the proposed income-tax cut -- which was a badly needed move in the right direction -- the deficit is likely to exceed $50 billion again in the next fiscal year. At this stage of the business cycle, we should be moving rapidly toward a budget balance or even a surplus, primarily by bringing spending under control. Instead, Congress voted recently to boost spending $45 billion to $499 billion next year -- a sharp 10-percent increase.

We all welcome President Carter's threat to exercise his veto authority to keep spending under control. We also appreciate his call for private decision makers to keep wage and price increases significantly below the averages of the past two years. But we should recognize the limitations of such incomes policies, which tend to treat symptoms rather than causes. In the present case, organized labor has already rejected the idea of wage restraints, preferring to see first what happens to prices. And in the last analysis, the historical record clearly shows that incomes policies don't work against inflation, in the absence of fiscal and monetary restraints.

Inflation and Monetary Policy

Up to now, the Federal Reserve has carried most of the burden of fighting inflation. The Fed is playing its accustomed role, attempting to balance the amount of credit available with the U.S. economy's ability to produce goods and services. In recent months, with excess demand showing up in the economy, the Fed has had to act by tightening up on bank reserves -- and as a result, we've seen a significant rise in short-term interest rates.

Now, the Fed certainly does not take any perverse pride in watching interest rates go up. It acts to tighten money only as a means of curbing inflation, because it knows fully well that the only certain way to keep rates low in the long run is to wring inflation expectations out of the economy. (After all, it is these expectations that cause lenders to demand more and more for the use of their money.) To achieve its goals, the Fed specifically intends to maintain money growth at a slower pace this year than last, especially since we overshot our targets on money-supply growth last year. This point emphasizes the Fed's firm commitment to a gradual reduction in money growth to a pace more nearly consistent with reasonable price stability, while still providing adequate money and credit for continued economic growth.

Concluding Remarks

All in all, the economy and the financial markets remain in relatively good shape at this stage of the business expansion. But to continue on the right path, we must reverse the accelerated inflation that has occurred so far in 1978. And bringing inflation under control requires a joint effort on the part of all sectors of the economy -- government and private alike.

Federal Reserve Chairman Miller recently said that the Fed will be doing its "day-to-day, week-to-week, month-to-month job of leaning against inflation," but the Fed can't do the job alone. In fact, final success in the fight against inflation means curbing Federal deficit spending.

For Oregonians, the fight against inflation should be even more crucial than it is for others, because of inflation's double impact on the state's economy. Oregonians, like everyone else, suffer from the cutback in purchasing power caused by inflation. But you also suffer from the impact of rising prices on the nation's housing industry, and thereby on the state's crucial lumber industry. As you've seen in the past, the upward pressure of inflation on market interest rates could lead to an outflow of funds from the nation's thrift institutions, and could thus reduce the amount of funds these institutions have available to lend on mortgages. Moreover, the high rates the thrifts would then have to charge for mortgage money would sharply increase the amounts needed to carry monthly payments, and thus force increasing numbers of families out of the housing market. So my final message is this -- until inflation is defeated, Oregon's key industry, and the state's economy as a whole, could remain at the end of the line in a continuing game of crack the whip.

# # # #