OIL, THE ECONOMY, AND INFLATION

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

Anchorage Chamber of Commerce

Anchorage, Alaska
July 24, 1978
Oil, the Economy, and Inflation

I'm glad to visit again a land where the sun is always shining -- at least during part of the year -- and to see for myself how Alaska is settling down in the post-boom period. In my talk today, I'd like to highlight some of the factors that will help determine whether Alaska's present condition of slow but stable growth will continue. The state of the world oil market is one such factor, but equally important is the outlook for production and prices in the national economy. But before I get into those questions, let me say a few words about your other visitors -- the able and diverse group of individuals who make up our Seattle office's Board of Directors.

The directors at our five offices are concerned with each of the 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.

Diversity of Directors

The diversity of the occupations and groups which they represent makes their advice even more valuable to us. Consider the Seattle Board alone. Alaska's banking community is represented in our councils in the person of Don Mellish. Then, Harry Goodfellow and Rufus Smith bring to us the viewpoints of the Washington banking community. Merle Adlum helps
with the long experience he has gained with the labor movement and with the Seattle Port Commission, and Virginia Parks brings us the viewpoints of the accounting profession and the academic community. In addition, we get useful insights into the state of the consumer markets from Doug Gamble, the retailing executive, and from Lloyd Cooney, the Seattle Board chairman and a leading broadcasting executive.

Our directors constantly help us improve the level of central-banking services, and in the most cost-effective manner. Above all, they help us improve the workings of monetary policy. As one means of doing so, they provide us with practical first-hand inputs on key developments in various regions of this District and various sectors of the economy. They help us anticipate changing trends in the economy, by providing insights into consumer and business psychology which serve as checks against our own analyses of statistical data.

We all benefit too from on-the-spot visits, such as this one here today, which showed us that Alaska's economy didn't collapse as soon as the pipeline-construction period came to a close. Despite some necessary readjustments, future growth seems assured. This is partly because of the solid foundation provided by government spending, with one-third of the jobs provided by Federal, state and local payrolls. Equally important is the growing long-term demand for forest and fishery products and for tourist services. Above all, there is the upsurge in world demand for Alaska's energy resources in an energy-short world.

**Dependence on Foreign Oil**

But let's take a look at the oil situation today, when we hear the word "glut" as often as we hear the term "shortage." Let's consider the
shortage aspects first. Nearly five years have passed since the Arab oil embargo and the four-fold increase in OPEC oil prices made us so painfully aware of our growing dependence on insecure sources of energy overseas. Yet despite the upsurge in the price of foreign oil, from $3 to almost $14 a barrel, the U.S. has had no real success in slowing the growth of imports, as the other summit leaders pointed out to President Carter last week-end. On the contrary, U.S. imports of crude and refined products have doubled over the past half-decade, and the import share thus has risen from 29 to 47 percent of our total annual supply. Over this 1972-77 period, oil imports jumped from $5 billion to $45 billion a year, reflecting sharp increases in both the volume and price of OPEC oil shipments.

But why hasn't the increased cost of imported oil done more to slow the growth of domestic energy consumption and to stimulate domestic production? There has been a modest impact, with the ratio of energy consumption to GNP falling by one-half percentage point over the past half-decade, but certainly no significant decline. Well, as you all know, a system of Federal price controls has been in effect during this period, acting to shelter the domestic market from the full impact of the world price upsurge. While domestic producer prices of oil have risen sharply, price controls have held the average far below the world price level. At the same time, the entitlements program has subsidized purchases of foreign oil to equalize the situation between refineries reliant upon these higher-cost supplies and refineries reliant on lower-priced domestic oil.
The price-control program admittedly has softened the economic impact of the world price upsurge, but it has also encouraged the growth of domestic oil consumption and discouraged domestic exploration. Also, the entitlements program has eliminated the cost penalty associated with high-cost foreign oil that might otherwise have curbed foreign purchases. Meanwhile, Federal controls on the wellhead price of natural gas sold to interstate pipelines have had similar effects, by creating distortions in the cost and availability of supplies among various consuming regions, and by placing an artificial lid on average gas prices.

Role of Alaskan Oil

This year, North Slope oil has begun to displace some foreign crude, and thus has helped contribute to the recent talk of a "glut." For this and other reasons, imports of crude and refined products dropped 14 percent between the first quarter of 1977 and the first quarter of this year. Still, the 1.1 million barrels flowing daily from Prudhoe Bay represent only a small part of the 9.0-million-barrel daily flow that we had been importing prior to the opening of the pipeline. And as domestic consumption continues to grow, dependence on foreign imports will once again increase, unless we sharply expand our supplies from Alaskan and other U.S. fields.

Now, it's true that West Coast refineries are able to absorb only about 550,000 barrels of North Slope oil a day, given the other demands on this refinery capacity. Thus roughly half of Prudhoe Bay's current output is surplus to the West Coast's needs. But press reports of a nationwide glut are just plain wrong. On the contrary, the U.S. needs
every barrel of oil it can produce, as is seen from our continued heavy
dependence on foreign imports. The "glut" is simply a localized problem
reflecting, first, the technological and output characteristics of West
Coast refineries, and second, the lack of necessary pipelines to transport
the West Coast surplus to shortage areas, such as the critically short
Northern Tier states that are heavily dependent on fast-disappearing
supplies of Canadian crude.

Today, the crude oil that is surplus to West Coast needs is being
transported by tanker to the Gulf Coast via the Panama Canal. Looking
at the map, some industry experts have suggested exporting North Slope
oil to Japan, with Japan-bound crude from the Middle East being diverted
to the U.S. Gulf and East Coasts. A swap arrangement of this sort would
reduce our large trade deficit with Japan, and might result in some cost
savings to refiners and consumers in the Eastern United States. However,
this short-run solution to a localized "glut" doesn't solve the long-term
problem of transporting Alaskan oil efficiently to the U.S. market.

On these grounds, a strong case can be made for an alternative
approach -- constructing the necessary pipeline spurs that would link
West Coast ports with refineries further East. The major contenders
seem to be a Northern Tier pipeline extending from Port Angeles, Washington,
to Clearbrook, Minnesota, and a so-called SOHIO pipeline linking Long
Beach, California, and Midland, Texas. In any event, removal of the
transportation bottlenecks would permit North Slope producers to proceed
with plans to expand Prudhoe Bay production to 2.0 million barrels a
day by 1985.

Decisions made in the world oil market thus will strongly influence
Alaska's prospects in the years immediately ahead. The pipeline is now
a permanent presence in Alaska's economy, for at current production rates and wellhead prices, the state's government may earn close to $1 billion annually in taxes and royalties from Prudhoe Bay alone. But national economic trends will also influence the state's prospects, so let's consider the situation developing in the Lower 49 states.

Prospects for the Economy

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 5.3-percent annual growth rate over that 3 1/2-year period, and only two of the quarters in that period have been substandard in growth -- including the weather-affected first quarter of 1978. Moreover, we have created almost 10 million new jobs in this business expansion -- about as many as in the preceding eight years put together. Indeed, we seem to be effectively fully employed, and scarcities of trained workers are developing in many industries.

At this stage, the big question is whether the expansion can continue. On balance we should 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 shown more strength than expected in the first half of 1978. Still, they may weaken later, partly because of the heavy load of debt assumed by consumers over the past several years.
Meanwhile, we may see a speed-up in activity by some of the former slow-growing sectors of the economy. For instance, inventory spending should accelerate this summer and fall, because stockroom shelves have been swept bare in the hectic buying of the past few months. Again, plant-equipment spending may strengthen, at long last, as business firms realize the need for new capacity. 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.

Deficits and Prices

Altogether, there still seems to be considerable life left in the business expansion. However, 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. Of course, we shouldn't expect a downturn simply because of the longevity of this business cycle. Business expansions don't die because of old age, but rather because of riotous living in earlier stages of the cycle. But unfortunately, we have indulged in some riotous living -- 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, could be traced in large part to the highly inflationary implications of a massive Federal deficit in the midst of a strong business expansion, amounting to almost $100 billion over the 1977 and 1978 fiscal years. And despite the reduction and postponement of the proposed income-tax cut, close to $50 billion worth of red ink may be added to the books in
fiscal 1979. 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 by $45 billion, to a total of $499 billion next year.

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.

Today, many observers also fear Washington's tendency to create more inflationary pressures through new legislation. These include the cost and price increases associated with the minimum wage, social-security and unemployment-insurance taxes, the steel "reference price" system, sugar and grain price supports, postal rates, energy policy, the recent coal settlement, and so on. By some calculations, government actions of this sort may add a full percentage point or more to the basic rate of inflation.

The recent acceleration of prices is indeed worrisome, no matter what the source. Consumer food prices, always highly visible, increased at a 16-percent annual rate over the past half-year. Consumer prices exclusive of the volatile food and energy components -- that is, items accounting for three-fourths of the entire consumer market basket -- have
risen at an 8-percent rate during this period, in contrast to their much lower 5-percent rate of increase during the second half of 1977. On the industrial front, purchasing agents month after month report paying much higher prices. Everyone is now paying more for steel -- that basic metal underpinning our entire economy -- and for everything else besides.

**Inflation and Interest Rates**

Similarly, everyone reports paying more for that other essential material -- money. Short-term market rates have risen as much as 3 percentage points above their 1977 lows, so that commercial paper (for example) is now selling at more than 7 3/4 percent. Most long-term rates meanwhile have risen at least one full percentage point above their 1977 lows, so that high-grade utility bonds (for example) now yield almost 9 1/4 percent. And judging from some newspaper stories, the Federal Reserve is solely to blame for this surge in borrowing costs.

Most people realize by now that the Federal Reserve is able to put upward pressure on rates in the short-run through a tighter monetary policy. Many people -- but not everybody -- also realize that a rising demand for funds in a strong business expansion can put similar pressure on rates. But relatively 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. Yet 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 -- perhaps 9 percent in all -- to protect themselves against an expected long-term loss in the purchasing power of their money. But borrowers will be willing to pay this inflation premium,
because they would expect to repay their loans with dollars that are worth 6 percent less each year than the dollars they originally borrowed. So if the Fed shifted to a policy of aggressive ease in today's circumstances, long-term rates at least would probably go up rather than down, because of an expectation of worsening inflation.

**Inflation and Monetary Policy**

One point that should be emphasized is that the Fed does not take some perverse pride in watching interest rates go up. It acts to tighten money only as a means of restraining the excessive growth of money and credit, as its contribution to fighting inflation. The alternative is to watch the distortions of inflation bring about a recession and more joblessness, as we have seen from long experience in this country as well as abroad. With a worsening of unexpected inflation, households would become uncertain about the future value of their real incomes, and thus tend to cut back on their spending plans. Similarly, under such conditions, businesses would become more uncertain about the rate of return on new capital, and thus tend to reduce investment in new plant and equipment. The actions of both groups would lower the total level of demand in the economy, and thus lead to less production and more unemployment.

Now what specifically does the Fed have to do when it receives mixed signals about the future of the 1978-79 economy? Logically, it concentrates on the one "off plan" component of the nation's economic strategy -- that is, inflation. As Chairman Miller pointed out in recent Congressional testimony, the Fed 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. In other words, the Fed is aiming at 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

On balance, I see Alaskans watching a number of developments with mixed emotions in the coming year. I see them happily watching the oil flow through the pipeline and the oil revenues pile up in their own coffers. But I also see them watching with concern the production statistics and (especially) the price statistics from the Lower 49 states. Businesses, consumers and governments all will be seriously damaged if inflation is not controlled. But bringing inflation under control requires a joint effort on the part of all of these sectors of the economy. 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 we all know that the Fed can't do the job alone.

Inflation, finally, is the key point at issue in regard to the Federal Reserve's independent stance within the Federal government. The founders of the System knew very well that the power to print money is a difficult temptation for some elected Washington officials to resist. They realized that more Executive or Congressional control over the printing press would mean more inflation, whereas central-bank independence would mean less inflation. Now more than ever, in the midst of one of the most inflationary decades of the past century, we need that anchor to windward.

##########