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FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

BUSINESS PROSPECTS IN 1979

Remarks of
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Meeting with Portland Community Leaders and
Board of Directors, Portland Branch,
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Business Prospects in 1979

I'm glad to be here in the Rose Capital once again--and I'm tempted, given the state of the outlook, to say at the outset that "I never promised you a rose garden." But before I get into the details, let me add how happy I am that Portland's community leaders can have this chance to get together with the directors of our Portland office. Our directors are an able and diverse group of individuals, as you can easily see, and they help in many ways to improve the performance of the Federal Reserve System.

The directors at our five offices are concerned with each of the major jobs delegated by Congress to the Federal Reserve. That encompasses the 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 them in each of these four areas.

Our directors constantly help us improve the level of central-banking services, in the most cost-effective manner. Most of 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. Our directors thus 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 economic data.

The Expansion to Date

We need their insights now more than ever, because of the vast uncertainty surrounding the outlook for 1979. But before analyzing what lies ahead, let's consider how far we've come since the dismal recession days of early 1975. Today, three and a half years later, the U.S. economy is still in the midst of the strongest and longest peacetime expansion of the past generation. 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, throughout those several years. Total output (after price adjustment) has grown at a healthy 5.2-percent annual rate since early 1975, and the expansion has proceeded fairly evenly throughout, with only two quarters of substandard growth.

Yet this prosperity has been badly undermined by the sharp decline in the value of the dollar, in the world's financial markets as in our domestic supermarkets. This severe inflation can be attributed to a number of factors, but largely to the continuation of massive Federal deficit financing long after such stimulus had become unnecessary. In this respect, we have been badly served by those commentators who insisted that further stimulus was necessary because traditional rules of thumb pointed to substantial slack in the economy--when our own senses suggested just the reverse. (Just ask anyone who's tried to hire an experienced computer specialist lately.) In contrast, my research staff has been

pointing out that inflationary pressures increase when the unemployment rate hovers around 6 percent, or when manufacturing production reaches 82 percent of capacity, as has been true throughout all of 1978. Thus, those analysts who use outdated yardsticks, ignoring all the changes that have occurred in the structure of the economy in recent decades, have only heaped more tinder on an inflationary bonfire.

Prospects for '79

Against that background, what can we anticipate in 1979? "Slowdown" may be the best description -- a period of sluggish business activity, but one with an overly high level of inflation. On the favorable side, there's still a good deal of momentum left in the business expansion, fueled by the sharp increases achieved in employment and income during the last several years. But as I just noted, a number of stresses have begun to show in the fabric of the economy. The nation is now at practical full employment of skilled and even semi-skilled labor, and it has also reached practical full utilization of cost-effective plant capacity. And now, we've been forced to impose several policy-tightening measures because of the severe inflationary pressures undermining the economy.

One major question concerns the future of consumer spending, which has played such a large role in keeping the expansion going these past several years. In other words, will the consumer be retrenching, especially in purchases of autos and other durable goods, in response to inflation-bred insecurity and very high debt commitments? Some cutback in credit purchases seems inevitable, given the environment of tightening credit, and given the unsustainable earlier credit buildup--after all,

net funds raised by households in the 1977-78 period have been running about 50 percent higher than the 1976 pace, and almost double the rate reached in any earlier year. Despite the credit surge, we've already seen a deceleration in real consumer spending in 1978, with a gain only about half as large as the average increase of the several preceding years, and that reduced spending pace may well continue into 1979.

Another question concerns how resistant housing activity will be to rising interest rates. In the past, when credit conditions tightened, mortgage activity slumped badly because thrift institutions were unable to compete for funds in an environment of interest-rate ceilings. That situation has not applied recently, because the thrifts are now able to compete for deposits in the form of six-month certificates tied to Treasury-bill yields. As a result, housing starts have remained quite high, at more than two million units annually, and permit activity has even strengthened. Nonetheless, even if funds remain available, the higher cost of credit for builders and borrowers is bound to affect the level of housing activity--although nothing like what we have experienced in past credit crunches.

Favorable Signs

One of the favorable signs in the present situation is the lack of excesses in the business-spending sector, such as marred the 1973-74 period. At that time, business firms aggressively expanded their commitments for inventories, plant and equipment, even in the face of an obvious retrenchment in consumer spending. In contrast, business firms today have been quite cautious in their forward planning.

Inventories remain lean in relation to current sales levels, and business-spending surveys indicate only a modest increase in plant-equipment spending, so it seems quite unlikely that there would be a sharp cutback in response to any weakness in end-product markets.

An even more favorable sign is the recent upsurge in U.S. exports, and the likelihood of continued strength in 1979. Export sales, after rising only 6 percent last year, jumped 22 percent between the first and third quarters of this year alone. Export growth, moreover, was evident in most product categories and in most geographic areas, which suggests that dollar depreciation is now boosting the competitiveness of U.S. goods. Import sales meanwhile grew only about one-third as fast as export sales over this recent period--and remained practically stagnant in physical volume terms. These trends thus suggest needed support for domestic business activity, as well as a welcome and long-awaited improvement in the nation's balance of payments.

Regional Implications

These developments, on balance, suggest a definite slowdown in business activity next year, but not necessarily a recession. Indeed, with any improvement on the inflation front, the prospects for certain sectors--such as housing and business capital spending--should improve substantially. But let's pause for a moment to consider some of the implications of all these developments for regional business activity. It used to be that a tightening of the nation's credit markets would create severe damage in the Pacific Northwest, as credit-short builders

slashed their demand for lumber products nationwide. Well, it hasn't happened this time, as I've already noted. The national housing industry, which strongly influences regional business activity, should be in a slump right now. But the mortgage-credit squeeze has been smaller than expected, and in addition, demand has continued high because of a sharp increase in the number of young buyers looking for housing, both as a place to live and as an inflation hedge.

A more important reason for confidence is the growing size, diversity and efficiency of the Oregon economy. Oregon today is a key part of the Sun Belt--I'm referring to the business climate, of course, not the meteorological climate. Among the larger states, Oregon stood fifth in the nation in terms of population growth over the 1970-77 period. That 13½-percent population increase thus has laid the foundations for a broader and more diversified economy, and has reduced the state's dependence on the nation's volatile housing industry. In typical Sun Belt fashion, Oregon's employment this year has been running about 10 percent ahead of a year ago--more than double the strong increase recorded elsewhere. And despite the signs of weakness in the national housing picture, Oregon's economy should benefit from a number of other developments--such as the turnaround in the cattle market, the rising prices for a bumper wheat harvest, and above all, the improvement in export prospects because of the past year's depreciation of the dollar.

Measures for Curbing Inflation

The regional outlook, like the national outlook, would be rather bright if we didn't have to contend with the severe disease of inflation,

which has been eating away at the vitals of the entire U.S. economy. The President's Economic Report said at the start of the year that an inflation rate of about 6 percent had become imbedded in the economy. Unfortunately, events have long since overtaken even that dismal statistic. Food prices, always highly visible, have jumped 10½ percent over the past year, while other consumer prices have risen almost 8 percent over that period. More ominously for the future, wholesale prices of crude materials are now more than 20 percent higher than a year ago. Indeed, most analysts foresee only modest improvement in 1979, because of the pressures generated by the depreciation of the dollar, the leapfrogging of wages and prices, and the recent experience of fiscal and monetary stimulus. Altogether, 1979 is likely to close out the most inflationary decade in the nation's peacetime history.

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 to expand the supply of goods and reduce the supply of dollars. As those basic remedies take hold, they should improve foreigners' confidence in the dollar and hence reduce the pressure of imported inflation from dollar depreciation. Meanwhile, the Administration's wage-price guidelines could help curb the pressures arising from the wage-price spiral, through the 7-percent lid on annual wage increases and (essentially) a 6-to-6½ percent lid on annual price increases. Incidentally, the wage guidelines of the 1960's were set no higher than the 3.2-percent trend rate of productivity growth for that

period, which suggests that today's 7-percent wage guideline is far too high--especially considering the fact that productivity growth recently has lagged far behind the pace of the 1960's.

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. The productivity increases of the past 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. But after our recent weak performance, there are now 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. The recent tax bill contained several provisions that should stimulate productivity-enhancing investment. Even so, the necessary investment won't be forthcoming without an inflation-free environment of greater certainty for business planning.

Basic Cure for Inflation

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 stimulus of massive deficit financing in the midst of a strong business expansion. Deficit financing has continued not

only during the recession, when it was highly useful, but also in the ensuing expansion period, when it was actually counter-productive. Consequently, the 1970's will end with a mind-boggling $326-billion combined deficit for the decade--more than the total deficit for the entire earlier history of the Republic.

The problem lies basically with our inability to curb spending. In this fiscal year, for example, Federal spending is scheduled to rise by $41 billion--a sharp increase of almost 10 percent. There is considerable evidence to suggest that the government's business could be transacted without an increase of that size, and at considerably less than the budgeted total of $492 billion. According to a recent Gallup poll, the public believes that 48 cents of every Federal tax dollar is wasted. That figure seems a bit exaggerated, but it's worth noting that the Inspector General of the Health-Education-Welfare Department estimates that waste eats up about 5 percent of the HEW budget--that's $6½ to $7½ billion for that department alone. Proper management, and proper Congressional oversight, would also curtail or eliminate those government programs which have long since lost their reason for existence.

The problem of Federal overspending has been compounded by the inflationary pressures generated by government regulations and government programs that boost business costs. No matter how worthwhile the regulatory goal--for example, through environmental, health and safety legislation--the regulations boost costs through direct administrative expenses and (above all) through the added expenses of business firms which must comply

with the government directives. In addition, there are the cost and price increases flowing from programs which Congress has legislated in the past for a number of different purposes. As an example, employment costs will ratchet upward next month because of sharp increases scheduled then in the minimum wage and in social-security taxes. By some calculations, government programs of this type may add a full percentage point or more to the basic rate of inflation.

Monetary Policy Considerations

Deficit spending has created trouble for anti-cyclical monetary policy, in two different respects. First, massive budget deficits in the past have pushed monetary policy in an expansionary direction, measured by the trend of either M_1 (currency plus demand deposits) or M_2 (currency plus all bank deposits except large time certificates). Over the past year alone, both measures of the money supply have increased about 8 percent--close to or even above the upper limits of their target ranges. But secondly, an overly expansive fiscal policy has now thrown the entire burden of fighting inflation on monetary policy. This means that further tightening could severely affect those sectors most vulnerable to a credit squeeze--agriculture, housing, small business, and state and local governments.

The Federal Reserve is in the middle in more ways than one. Some observers claim that the Fed hasn't tightened nearly enough, judging from the past growth of the money supply or the recent upsurge of activity in the bank-loan and commercial-paper markets. Other observers claim that the Fed has tightened far too much, judging from the recent upsurge in

interest rates--with, for example, the prime business-loan rate almost twice its 1977 low at 11½ percent. But the Fed's goal remains steadfast--reducing money growth over time, to a level consistent with relative price stability, even while ensuring that enough credit remains available to avoid a severe business downturn.

I should emphasize in this connection that the Fed doesn't take any delight in seeing interest rates go up as they have in the past year. Short-term rates are now about 5 percentage points above their 1977 lows, partly reflecting the tightening of monetary policy, but also reflecting the recent boom-level demands for credit. But I would suggest that you keep your eye on long-term rates--the key rates for home buyers and business planners--which are now about 1 percentage point or so above their 1977 lows. These rates generally embody some long-term "real" interest rate plus an inflation premium. Yet the point to remember is that they actually softened after the November 1 credit-tightening announcement, because potential borrowers and lenders decided that they would be satisfied with a smaller inflation premium in the future. Thus, any shift toward credit stringency that promises progress against inflation almost certainly will lead to lower rather than higher long-term rates.

Concluding Remarks

In closing, I should point out that our nation's recent economic performance has been full of bright as well as dark spots. Since the dismal days of early 1975, the $2-trillion U.S. economy has grown 19 percent in real terms, and in the process has created over 10 million new jobs. And despite inflation, per capita disposable income--a key

measure of personal well-being--has increased 13 percent in real terms since that recession low. But all those accomplishments may go for nought if we don't get inflation under control.

Given these circumstances, some slowdown in business activity seems to be both likely and desirable in 1979. Further stimulus, of the type experienced in the past year or so, will not lead to further growth but only to ever-worsening inflation. But the required program of policy tightness must be well-balanced, with fiscal policy now carrying its share of the burden, through a slowdown in Federal spending and a consequent reduction in Treasury borrowing pressures on credit markets. We need to be certain that every possible weapon is brought into action in our all-out war on inflation.

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