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INFLATION AND THE BUSINESS OUTLOOK

Remarks of

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Meeting with Pendleton Community Leaders

and Board of Directors, Portland Branch,

Federal Reserve Bank of San Francisco

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Inflation and the Business Outlook

I'm glad to be here today, even though I'm several months early for the world-famous Round-up. And it's a real treat to visit an area where the land is rich, the water is clear, and the gas lines are short -- or at least shorter than in California. But on the subject of gas lines, I think you should know that many Californians are showing the old pioneer spirit in dealing with this crisis. In Beverly Hills, for example, an enterprising businessman has started a new club -- an attendant will pick up your car at home, find a gas line to wait in, and fill up your tank, all for only $50 a month plus $150 initiation fee. And in San Diego, a pro football player who got tired of waiting in line to gas up his Rolls Royce has gone out and purchased a gas station for himself and his friends.

Here in Pendleton, I see that you've given some thought to the problem too, judging from all those bumper stickers that say, "A bushel of wheat for a barrel of oil." As a consumer of bakery products, I'm not sure I approve, but as an observer of the world economy, I think that that bumper-sticker writer has come up with a good idea. Americans frequently forget that we have some strong cards to play in the competitive struggle for world markets, and it's good to be reminded of the natural wealth we have, in the grain fields of Eastern Oregon and elsewhere.

Role of Fed Directors

We all gain a great deal of benefit from visiting this area to see developments for ourselves, and I hope that you too gain from the opportunity to get better acquainted with the able and diverse group of people who make up the board of directors of our Portland office. Let me spend a minute to tell you the many ways that those individuals help 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 economic sectors and in various geographic areas. 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.

Our directors, in particular, give us a good indication of both the short-term and long-term prospects for the regions that they represent. For example, Phil Schneider of our Portland board has contributed to the work of the Oregon 2000 Commission, which recently came out with a very useful report. That report drew attention to the difficulties faced by the agricultural sector, as well as the forest-products industry, because of the changes brought about by population growth, urbanization, and industrialization. The report also highlighted the growing importance of the world market for Oregon's ranchers, with foreign purchases rising from 10 to 20 percent of Oregon's total farm production between 1969 and 1977 alone. Insights into regional developments, such as these, help us immeasurably in devising policies to deal with shifts in the national and international environment.

Prosperity and Recession

Let's turn now to the national scene, and consider what may lie ahead for the next year or so. But first, consider how far we've come since the dismal recession days of early 1975. Today, four years later, the U.S. economy appears to be at or near the peak of the strongest and longest peacetime expansion of the past generation. The Korean War expansion was somewhat stronger, and the Vietnam War expansion was somewhat longer. But no other expansion of the past generation could match the economy's recent performance, with total output (after price adjustment) rising at more than a 5-percent annual rate over this prolonged four-year period. Moreover, the expansion has proceeded fairly evenly throughout, with substandard growth apparent only in several quarters of the past four years, despite what you may have read in some newspaper headlines.

Yet this prosperity has been badly undermined by a persistent and accelerating inflation, caused in part by food and fuel shortages, but primarily by the continuation of massive Federal deficit financing long after such stimulus had become unnecessary. Unfortunately, many policymakers were led astray by those analysts who argued for further stimulus simply because traditional rules of thumb pointed to the existence of continued slack in the economy. Common sense suggested otherwise, as anyone can tell you who has tried to find experienced workers in the past year or so. Moreover, my research staff has pointed out time and again that inflationary pressures increase when the unemployment rate reaches 6 percent of the labor force, or when manufacturing production reaches 82 percent of capacity, as has been true for the past year or more. 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 the inflationary bonfire.

But now to the key question -- are we heading into a recession? The signals today are mixed -- for example, some indicators that declined last month may bounce back this month -- and that fact of course complicates the task of policymakers who must make decisions that will affect the fate of the economy for years to come. But on balance, most economists see significant weaknesses developing in the economy, aggravated by inflation and by the latest squeeze on the nation's fuel supplies, and most see a brief and mild recession developing because of those weaknesses. A severe downturn is unlikely; as a matter of fact, total output could increase, on average, in both 1979 and 1980, even if we experience several quarters of weakness during this period. But recognizing the danger is the first step in devising measures to guard against recession, while we continue the long and bloody struggle against inflation.

Signs of Recession

The case for recession rests partly upon the weakening, in three of the last four months, of the index of leading indicators. That index, while not always reliable, definitely signals a near-term deceleration of business activity, and beyond that, it may signal the beginning of a recession. Consumer spending, which accounts for two-thirds of total spending, has already shown signs of weakness. This is understandable, given the fact that the employment and income statistics flattened out during the early spring months. This suggests in turn that the weakness evident in the first-quarter GNP figures, in real terms, will show up in the second-quarter GNP figures too. The long-awaited downturn in the housing market also seems to have arrived, judging from the recent weakness in housing starts and the slowdown in deposit inflows at thrift institutions.

One major indicator of deceleration is the slowdown of money growth evident since last November, when the Federal Reserve tightened policy as part of the program of shoring up the badly weakened dollar in the world's financial markets. Over this past half-year, we've witnessed an actual decline in the narrow monetary measure, M_1 (currency plus bank demand deposits) -- although much of that decline may be traced to the growth of automatic transfer accounts and other factors. The broader measure, M_2 (currency plus all bank deposits except large time certificates), has increased over this period, but significantly below its targeted growth rate. While the monetary aggregates aren't infallible measures, their recent weakness signals a definite slowdown in business activity in coming months.

The evidence suggesting a recession isn't all one-sided, of course. Business firms, now operating near the limits of capacity, say that they will boost their spending for new facilities significantly this year. On the other hand, actions speak louder than words, and they've sharply reduced their new orders for capital-goods equipment recently. Business firms also have shown little sign of a rise in inventory-sales ratios, as normally happens when sales fall below expectations and unwanted inventories pile up. On the other hand, that situation could turn around quickly, as we've seen at the turning point of most business cycles. (Incidentally, you may have noticed that this is a bad year for one-armed economists, because they've been using that "on the one hand. . .on the other hand" routine now more than ever.) In any event, the mixed nature of our indicators suggests that the downturn, if it comes, will be relatively modest.

Oregon Farm Prospects

Business activity in Eastern Oregon will be affected by all these national cross-currents, of course, but it will also be affected by special factors -- especially developments in the world's wheat market. As you know, more than 80 percent of the Pacific Northwest's wheat crop is exported, and there's an increasingly strong market out there, since the worldwide market has doubled in the past quarter-century and is continuing to expand. As for the nation's supply situation this year, the spring crop may be down, but the much more important winter crop should be about 10 percent larger than last year's, despite all the problems you've had here in the Northwest. And despite the weather problems here and in other wheat-producing areas, the high level of stocks should keep prices from accelerating as they did over the past two years. The futures market, for example, sees only a 2-to-4 percent increase in prices between now and year-end. Thus, it still may be some time before wheat prices get anywhere near oil prices, despite the best intentions expressed in those bumper stickers.

In the cattle market, we're apparently reaching the low point of supplies after one of the sharpest cutbacks in herd size in the nation's history, from about 132 million head to about 111 million head over the past four years. This year, cattlemen are beginning to rebuild their herds, holding back heifers rather than selling them to feedlots for eventual slaughter.

With beef production down, cattle prices are roughly 35 percent ahead of year-ago prices, although futures markets indicate that the upsurge may have approached its peak for the year. Still, if past experience is any guide, I would not expect to see any sustained weakness in cattle prices for several more years.

Inflation Problem

Altogether, there are still many bright spots in the economic picture, both nationally and regionally. But the outlook has been darkened more and more by the severe disease of inflation, which for several years has badly distorted our structure of costs and prices. In a study last year, the President's Council of Economic Advisers said that an inflation rate of 6-6 1/2 percent had become imbedded in the national economy. But as we've seen, the situation is much worse than that. Even excluding food and energy prices, the consumer price index has risen 9 1/2 percent over the past year. Worse still, food prices are 12 percent higher than a year ago, energy prices are up 16 percent, and both of course have risen at a much faster pace in recent months. Ominously for the near-term future, wholesale prices of crude materials are about 17 percent higher than a year ago. Altogether, with this record, 1979 is closing out the most inflationary decade in the nation's peacetime history.

Well, what are we going to do about it? We may not be able to do much about the food price bulge, given the state of the weather and the shifts in the cattle cycle. But we can certainly do more to curb the upsurge in energy prices, especially by following through with price-decontrol measures which will help conserve present supplies and stimulate the development of new supplies. But above all, we must 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 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 $45 billion -- a sharp 10-percent increase. 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 $495 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 $6 1/2 to $7 1/2 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 ratcheted upward early this year because of sharp increases 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.

Federal Reserve Role

Now, in the face of huge government deficits in periods of high employment, why doesn't the Federal Reserve simply maintain a rate of monetary expansion which is consistent with price stability, and thus at least partly offset the inflationary effects of fiscal policy? Well, there are several institutional factors that complicate the Fed's job.

In the last analysis, no central bank has the authority -- nor should it have in a democratic society -- to nullify over an extended period the programs and policies of the nation's elected representatives. But needless to say, central banks should forcefully and publicly present their views on sound financial policy, and they should act decisively within the limits of their authority to follow appropriate policies to achieve such results.

The formulation of policy also is complicated by the lagged impact of monetary policy on the economy. The economy does not respond instantly to a change in the cost and availability of money and credit, but only with a lag -- which, unfortunately, is not constant and predictable. Moreover, the lagged impact of policy can be aggravated by the uncertainties of economic forecasting, resulting frequently (as today) from such outside shocks as oil crises and crop shortages.

Moreover, monetary policy is incapable in practice of offsetting the inflationary effects of large budget deficits in periods of high employment, because fiscal policy and monetary policy affect the economy in different ways. Changes in tax rates, for example, can quickly inject or withdraw purchasing power across a broad front in the economy, affecting most or all consumers and business firms. Monetary policy, on the other hand, operates indirectly and on a narrower front, by influencing the rate of growth of bank credit.

Not all sectors of the economy are equally dependent on bank credit -- and not all bank borrowers have equal economic power or credit standing. Very large companies and the Federal government also obtain funds from such sources as the money and capital markets. But those markets are not as readily available, if at all, to small businesses, consumers, farmers, home builders and state-and-local government units. Hence, those groups are usually affected first and most heavily by a program of monetary restraint, in contrast to the broader impact achieved by a program of fiscal restraint. Consequently, it may not be desirable -- or even practically possible -- to rely on monetary policy alone to combat inflation, especially when that problem is aggravated as it is by heavy deficit financing in a period of high employment.

Concluding Remarks

In closing, let me remind you that the nation has recorded some notable achievements as well as some obvious failures during this four-year-old business expansion. Since the dark days of early 1975, the $2.3-trillion U.S. economy has grown 22 percent in real terms, and in the process has created over 12 million new jobs. And despite inflation, per capita disposable income -- a key measure of personal well-being -- has increased 15 percent in real terms since the recession low. But all those accomplishments may go for nought if we don't get inflation under control.

The economy has been operating near the limits of capacity, so that some slowdown in business activity seems both likely and desirable in coming months. The Federal Reserve has played its part in bringing about the necessary slowdown, through the tightening of policy achieved over the past half-year. But at this point, fiscal policy should carry a larger share of the burden, through a slowdown in Federal spending and a consequent reduction in Treasury borrowing pressures on credit markets. We must be certain to bring every possible weapon into action in our all-out war on inflation.

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