



FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

INFLATION AND RECESSION

Remarks of
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Board of Directors, Portland Branch
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Inflation and Recession

It's always a pleasure to visit friends and acquaintances here in the Great Northwest, but I hope that the next time I'll be able to provide a more upbeat theme than "Inflation and Recession." That must surely be one of the most depressing phrases in the English language. I'll get into the details in a moment, but first let me add how pleased 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, 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 business and public life. 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.

Regional Strength

We've been getting a very favorable picture recently from our directors, as well as from our regional statistics. Indeed, in this fairly damp section of the Sun Belt, you'd hardly know there was a recession going on. Of course, the growth pace should slow down this year and next, and the situation could become bleak for some regional industries (such as tourism) if the energy crisis worsens -- but overall, Oregon's economy looks to be in very good shape to meet the challenges ahead. One important reason is the attractiveness of Oregon to new residents and investors; with a 17-percent population growth to date in this decade, Oregon is the fastest growing state on the Pacific Coast.

Oregon's strength is especially impressive in the light of the weakness of the national home-construction industry. After all, Oregon regularly produces one-fifth of the nation's lumber and two-fifths of its plywood, so by past trends the state's economy should now be weakening, as tight credit and high housing prices undermine nationwide housing demand. But the growing size, diversity and efficiency of the state's economy are compensating for any weakness in the forest products industry. In particular, the growth of the state's electronics and other high-technology industries, which have almost doubled their job requirements since early in this decade, promises considerable strength as we move into the 1980's.

Oregon's foreign-trade situation looks especially promising, partly because of the rapid growth of our Pacific Basin trading partners, and partly because of the dollar depreciation of the past several years.

Indeed, the cheaper dollar means that wheat and other Northwest products are selling at bargain-basement prices in the world's markets. Meanwhile, the state's homebuilding industry is holding up fairly well, while the commercial-construction boom continues apace -- incidentally, with the Maple Leaf flag flying over many of these projects. I understand that office space in downtown Portland has tripled over the past decade, and that almost 1 1/2 million more square feet will be added by the early 1980's. That sign of confidence by outside investors is perhaps the most fitting tribute to the strength and balance of Oregon's continuing expansion.

National Weakness

So much for the good news. When we turn to the broader national picture, we encounter a much bleaker situation. Indeed, if you like classical allusions, you could say that we are caught between the Scylla of recession and the Charybdis of inflation. Ordinarily, when the economy slows down, we adopt stimulative fiscal and monetary policies in order to get back on a proper growth path -- but we can't afford the luxury of such expansionary policies today. In view of the weakness of the dollar at home and abroad, we have had to adopt much more restrictive policies than we would normally follow in a period of economic weakness. But the policies we choose must be better integrated than they have been in the past. Monetary policy can't carry the burden alone, as I'll discuss further in a minute.

Let's consider first the dimensions of our present problem. We may now be in the early stage of the most widely heralded recession of recent times. Real gross national product -- that is, GNP adjusted for inflation -- moved

practically sideways in the first quarter of 1979, and then dropped at about a 2 1/2-percent annual rate in the second quarter of the year. This recent development followed the longest and the strongest peacetime expansion of the past generation. But the distortions introduced into the economy by the worsening inflation of the past several years undermined this solid expansion and finally brought on the day of reckoning.

Most observers doubt that things will turn out as badly in 1979 as they did in 1974-75, although there are some eerie parallels, such as a renewed energy crisis. The last time around, we suffered from the previous boom period's unsustainably high production levels in autos, housing, capital goods, and inventories. However, the relatively well-balanced expansion of the 1975-78 period kept output in most of those areas much closer to sustainable long-term needs. And even the oil-price shock has been relatively lighter now than it was in 1973-74.

Inflation -- and Policy Complications

But to repeat, inflation has undermined this otherwise strong situation. Consumer prices soared more than 13 percent, at an annual rate, during January-July 1979, which was about as bad as the worst upsurge of the 1973-74 period. Moreover, the food and energy sectors weren't the only sources of the problem. Those volatile sectors account for only about one-fourth of the consumer market basket, so we have to look to the rest of the market basket to measure the "underlying" rate of inflation. Well, the prices of those other goods and services increased at more than a 10-percent annual rate during the January-July period, which shows that our inflation problem is quite widespread and not simply restricted to a few headline-catching items.

We're all familiar with the spurt in inflation caused by the OPEC cartel's decision to boost prices, and in the case of food, by such factors as bad weather, heavy Russian grain purchases, and the decline in the cattle cycle. But a crucial inflation factor has been the excessive growth of the money supply during the past several years. The broad money supply, M_2 , defined as currency plus all bank deposits except large time certificates, increased at a 9-percent annual rate over the four-year business expansion -- and this was close to or even above the top of the target ranges successively set by the Federal Reserve during this period. Remember, though, that excess money creation does not stem from any perverse policy decision on the part of the Federal Reserve, but rather from the pressures imposed on the central bank by the need to finance an unprecedented series of massive Federal-government deficits.

Our problems have been aggravated even more by the sharp decline in the value of the dollar over the past several years, with governments and private businesses selling dollars because of their strong belief that U.S. expansionary policies would lead to an acceleration of inflation here at a time when prices were decelerating elsewhere. This problem wouldn't have been so important if the dollar were a minor currency; but for better or for worse, it is the key international reserve currency. About one-half of all world-trade transactions are conducted in dollars; about three-fourths of all Euro-currency transactions are handled in dollars; and about four-fifths of all official foreign-exchange reserves are held in dollars. When such a currency weakens, as the dollar has done in recent years, it undermines the strength of

the entire world economy. Hence, market participants abroad as well as at home are apt to demand the adoption of stringent anti-inflationary policies in today's situation.

Limitations of Monetary Policy

Now, let's consider why the money supply grew so expansively during the recent business expansion. To answer that question, we've got to understand the institutional factors which complicate the Federal Reserve's policy task. We central bankers can forcefully present our views on sound financial policy, and within the limits of our authority we can implement appropriate actions. But in the last analysis, a central bank in a democracy does not have -- and should not have -- the authority to nullify continually the policies of the nation's elected representatives.

Another complicating factor is the lagged impact of monetary policy. The economy does not respond instantly to each change in the cost and availability of money and credit. Rather it responds only after a lag of time, and that lag (unfortunately) is not constant and predictable. Moreover, in practical terms, monetary policy cannot offset the inflationary effects of large budget deficits during boom periods, because fiscal policy and monetary policy affect the economy in different ways. Monetary policy operates less directly and on a narrower front than fiscal policy, through its influence basically on the rate of growth of bank credit.

Yet problems arise because the various sectors of the economy don't all depend equally on bank credit -- and bank borrowers don't all have equal power or credit standing. Very large corporations, and of course

the Federal government, can 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, these groups are usually the first to be affected, and the most seriously hurt, by any program of monetary 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 has been by heavy deficit financing in a period of high employment.

Need for Moderate Fiscal Policy

In our search for a broad-scale and well-integrated set of policies to combat inflation and recession, we must first institute a moderate fiscal policy -- one which will not destabilize the 1980's as it did the 1970's. For example, the Treasury ended fiscal 1978 with a \$49-billion deficit, and it will probably wind up this month with a \$30-billion deficit for fiscal 1979. For the 1970's as a whole, we'll have a combined budget deficit of roughly \$320 billion -- just about equal to the combined deficit for the entire earlier history of the Republic. The problem lies basically with our inability to curb spending -- or alternatively, to raise taxes to finance it -- in periods of relatively full employment. In this fiscal year, for example, Federal spending will increase by about \$44 billion -- almost a 10-percent increase. Sound fiscal policy would call for a budget surplus, or at least a balanced budget, during strong business expansions in order to dampen inflationary spending and borrowing pressures.

During the Vietnam War period, defense spending was the major contributor to the spending upsurge. But more recently, the rise has been concentrated in civilian programs, especially the aptly named

"uncontrollable categories" of income-transfer payments. (Altogether, the Federal government's annual transfer payments to individuals have jumped from \$27 billion to \$197 billion just within the past decade and a half.) Once such open-ended programs are established, funds are disbursed (without specific Congressional action) in response to changing economic conditions. Under many transfer programs, entitlements increase automatically with any downturn in the economy.

Demography also plays a role, since age determines benefit eligibility for many programs, and there are more and more old folks around. In addition, inflation creates many automatic spending increases, because of escalator adjustments to income-security programs or because of the pass-through of rising health costs to the medicare and medicaid programs. According to a recent study by the General Accounting Office, spending will be very hard to control as long as we index in this fashion over half of the expenditures in the Federal budget.

Problems have also been caused by legislated cost increases. Congress in its wisdom has decided that certain regulations are necessary for health, safety and environmental reasons, but the costs of doing business have been boosted by the attendant paperwork and, especially, by the necessary new equipment. Again, employment costs have risen this year because of sharp increases in the minimum wage and in social-security taxes. (Indeed, within a 3-to-4 year period, we are incurring cost increases of 50 percent or more in both of those programs.) Then there are the costs arising from farm price-support legislation, and also from the subsidies and restrictions surrounding the rail, maritime, trucking, steel, construction and energy industries. By some calculations, government actions of this type add a full percentage point or more to the basic rate of inflation.

Separately, wage-push pressures have aggravated the problem of inflation throughout the past decade. Labor costs could remain stable, with no impact on business prices, if workers' productivity advanced at the same pace as their wages -- which unfortunately hasn't been the case in recent years. In the first half of 1979, in particular, labor compensation per hour rose at more than a 10-percent annual rate, while output per hour actually declined, and the resultant 14-percent rate of increase in unit labor costs led business firms to raise their prices substantially. The cure is not simply to hold down compensation through guideline pressures or whatever, but also to boost productivity.

Need for Improved Productivity

This year's performance is only the climax of a dismal period of weakness which has stretched back over the past decade. For several preceding decades, the U.S. led the world in productivity gains, with output per hour rising more than 3 percent annually, on the average. Those productivity gains provided us with the basis for a strong expansion in the real incomes of all Americans. But productivity growth has weakened in more recent years, averaging only one percent over the past half-decade. Meanwhile, German and French productivity gains have been twice as large as ours throughout the 1970's, while Japanese gains have been four times greater.

One key reason for this poor performance is a prolonged lag in the pace of capital spending. The productivity comparisons reflect the fact that we spend less than 10 percent of our GNP on capital investment, whereas the Germans spend 15 percent, and the Japanese spend more than 20 percent of GNP for that purpose. The solution, then, is to stimulate productivity-enhancing investment, primarily through improvements in our

tax structure. Reductions in business taxes would be useful, as a means of releasing funds that could be channeled into efficient new plant and equipment. Equally attractive is a major overhaul of depreciation allowances, such as the "1-5-10" formula which Treasury Secretary Miller frequently proposed while he was still Federal Reserve Chairman. This formula stands for a new policy of liberalized depreciation, under which all mandated investments for health-safety-environmental purposes would be written off in one year, all new investments for productive equipment would be written off in five years, and all capital in structures and permanent facilities would be written off in ten.

Concluding Remarks

To sum up, the nation's economic policymakers are in a real dilemma. Business-cycle considerations dictate relatively easy monetary and fiscal policies, as a means of offsetting the downturn in the economy. But other considerations -- inflation at home and a weakened dollar abroad -- dictate a much tighter set of policies, as a means of restoring the stability which is so essential to both our own welfare and the welfare of the entire world economy.

As I've indicated, we need an integrated and broad-scale attack on our nation's problems. Monetary policy can do its part by moving gradually to a rate of money-supply growth which is consistent with long-term price stability. But monetary policy can't do everything; we need proper tax, regulatory and energy policies as well. Our national economy is like a vintage automobile -- powerful in its prime, but now slowed down by poor maintenance and excess baggage. With a good overhaul it can do wonders, performing excellently at a good steady speed, but first the mechanics must work together to cure it of its deplorable tendency to exceed the speed limit one minute and go into reverse the next.