

INFLATION AND ENERGY PROBLEMS

Remarks of

John J. Balles, President

Federal Reserve Bank of San Francisco

**Meeting with Tri-Cities Community Leaders and
Board of Directors, Seattle Branch
Federal Reserve Bank of San Francisco**

Kennewick, Washington

May 2, 1980

Inflation and Energy Problems

I'm delighted to make my first visit to the Tri-Cities area, or Atomsville, U.S.A., in the words of the Wall Street Journal. According to a recent Journal article, everything here -- from supermarkets to gymnasiums -- has "atomic" in its name. That may be a bit of journalistic exaggeration, but it leads me to think that we could use some more places in this country that have "atomic" in their names. I'll have a few things more to say on that subject in a minute. But mainly, I'd like to focus my comments on the state of the national economy, which lately has resembled a Three-Mile-Island type of situation, with inflation threatening to get out of control.

First, let me point out one of the good things about meetings such as this, which is the chance it provides our directors to meet with Tri-Cities community leaders to discuss matters of common interest. 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.

Fundamental Economic Problems

At a time like this, we need all the help we can get from our directors -- and indeed from all of you. We must deal with an incipient recession, which ordinarily would suggest the need for a policy of stimulus -- but also deal with a severe inflation, which definitely calls for a policy of restraint. To understand the situation, we must remember that many of our difficulties arise from the fact that economic growth over the past decade depended very heavily on public-sector spending. In particular, massive Federal-spending increases outpaced tax revenues and created red ink on the books for every single year of the decade. Indeed, the combined Federal deficit for the decade, \$315 billion, matched the combined total for the entire previous history of the Republic. Inflation was the inevitable result of this prolonged series of deficits, the overly stimulative monetary expansion that sometimes accommodated them, and a series of supply-related shocks from the OPEC nations and elsewhere. Consumer prices practically doubled over the course of the decade, in the worst peacetime inflation in the nation's history.

We're paying the price in 1980 of failing to deal more forthrightly with the problems which originated in the 1970's. Recession, or a situation

closely resembling recession, is an obvious consequence of the past decade's excesses, and of the stringent policy moves needed to cure those excesses. The recent weakness of production, employment and retail sales, plus a five-month-long decline in the leading-indicators index which usually signals cyclical turning points, suggest that the long-awaited recession may finally be here. In other words, overall business activity may actually decline for several quarters, following the period of sluggish growth which has been evident since last fall.

I would emphasize, however, that recession is not the basic problem, but rather the consequence of our earlier actions. The basic problem is inflation, and this has been true throughout the past decade and more. Inflation undermined the otherwise commendable record of income and employment growth achieved during the 1970's, when consumer prices doubled within a single decade. Yet if the past year's trend continues, prices would double within a half-decade alone.

Energy Problem

Let's consider some of the factors that have been blamed for our severe inflation problem, beginning with energy. The numbing series of oil price increases of the past decade culminated in the doubling (or more) of OPEC prices in 1979 alone. In dollar terms, the U.S. paid less than \$5 billion a year to the oil exporters prior to the 1973 embargo, but it now is paying them almost \$57 billion a year for imported petroleum. The latest price upsurge has meant a 47-percent rise in energy costs for U.S. consumers since a year ago, as well as steep increases for producers which will filter through the economy for some time to come. And despite some

signs of a short-term oil glut, the long-term price outlook is not too good, especially as more nations follow the Iranian example, gaining increased revenue while sharply reducing supply.

On the more favorable side, the U.S. has provided good evidence that it can adjust to a world of higher energy prices. Even with limited price decontrol, per capita energy usage increased only 5 percent between 1972 and 1978, compared to a 21-percent increase in the preceding six-year period. (In volume, that difference amounted to about 6 million barrels a day.) And by decontrolling domestic crude-oil prices -- a process to be completed over the next 18 months -- the government is sending American consumers an unambiguous signal to conserve even more.

A growing economy, however, requires new sources of supply as well as increased conservation. We should develop our domestic sources of oil and natural gas, including synthetic fuels from coal or shale. We should develop exotic new sources of energy, such as solar and wind energy, as well as bio-mass and geo-thermal power. But above all, we should expand our dependence on proven efficient sources of energy, as anyone here in Atomsville (U.S.A.) can tell you. The essential nature of nuclear power becomes obvious when you consider what the industry means to the U.S. in terms of saving oil. There are now 70 licensed nuclear-power plants operating in this country, and over 100 more are on order or in process of construction. If all these plants were required to use oil instead of nuclear power over their lifetimes, they would consume more than the total proven oil reserves of the entire country, including Alaska.

The potential of nuclear energy can be seen by examining a single project, the Diablo Canyon plant in California -- which, unfortunately, is not yet in operation because of permit delays and litigation. But when in full operation, the Diablo plant will reduce the amount of fuel oil required to make electricity by 20 million barrels a year, which is equivalent to saving a month's supply of gasoline for all the 12 million cars in California. Again, the total cost of electricity generation at that plant will be only about 2 1/2 cents per kilowatt-hour, or no more than half the fuel cost alone of an oil-fired plant. Obviously, if we're serious about curbing inflation, we'll have to increase our dependence on such secure and economical sources of energy supply.

Inflation and Deficits

Next let's consider an even more basic cause of inflation -- the Federal budget. The budget seriously aggravated the inflation problem during the recent cyclical expansion by generating a massive series of deficits, which then induced a substantial over-expansion of the money supply. Part of the problem was the monetization of debt which resulted from the Federal Reserve's former operating techniques, which sometimes involved a slow adjustment to inflationary pressures because of the Fed's attempt to limit the impact of rising interest rates on private sectors of the economy. This link was broken last October 6, when the Fed shifted from an interest-rate operating technique to direct control of growth in bank reserves, and hence in the money supply. The aim since that time has been to slow the growth of the money supply to a point where it will be consistent with price stability.

But we're still experiencing the results of that earlier problem. Moreover, much of the run-up in inflation expectations early this year could be traced to the belief that our budgetmakers had lost control of that engine of inflation. The fears about a runaway budget surfaced before the ink was dry on the January document, when it became apparent that Federal spending would not be as "lean and austere" as projected a year ago. For fiscal 1980, the January budget document forecast a \$40-billion deficit -- 44 percent larger than last year's deficit. For fiscal 1981, continued deficit financing seemed inevitable, even in the face of about \$50 billion in tax increases -- either from the social-security tax, the windfall-profits tax, or inflation-related boosts in personal-tax revenues.

Inflation and Crowding-out

Now, substantial budget deficits can be defended in deep recession periods, because they support aggregate business activity at times when other credit demands are weak. But that condition hasn't existed in any of the last several years of essentially full employment. Instead, heavy deficit financing has led to intense pressure on credit markets and to greater inflation, by inducing an excessive monetary expansion -- understandably, because the Federal Reserve tended to lag in restricting credit availability to the private sector. As a result, interest rates have come under sustained upward pressure, and higher interest rates have "crowded out" many private borrowers from the money and capital markets, because they could not pay what the Treasury could pay for funds. Over time, this has helped cause a greater portion of aggregate savings to go

to the public sector, and thus has led to less productive investment and to a decline in the nation's real-growth potential.

The "crowding out" argument was widely discussed -- and also frequently ignored -- in the mid-1970's. But now we're face-to-face with the truth of that thesis. At a time of tight Federal Reserve monetary policy, and of a continued high level of private credit demands, the Federal government's borrowing demands have been rising rather than declining, with severe consequences for the markets.

Much of the Federal borrowing pressure comes from Federal entities which are classified "off budget," but which are still financed by the U.S. Treasury, such as the group of credit agencies operating under the wing of the Federal Financing Bank. Other pressures come from privately-owned but government-sponsored enterprises, primarily those operating in the mortgage market. In any event, total Federal and federally-assisted credit demands could reach \$95 billion or even more in calendar 1980. In other words, the Federal government and its agencies could pre-empt almost one-fourth of all credit demands, compared to less than a one-sixth share during the first half of the 1970's. Thus, none of us should be surprised at the stratospheric level of interest rates which results when money growth is obviously slowing, and when the Federal government is taking a larger share of available funds.

Need for Budget Balance

These considerations indicate why the drive for a truly balanced budget is at the heart of our anti-inflation struggle. It may be difficult to reach that goal in light of the need for real increases in defense

spending, but that simply means that stiff cutbacks elsewhere are essential if we are ever to reduce the government sector's excessive demands on the nation's resources. The Administration has made a good start by reopening the books on the 1981 budget, and proposing a \$16 1/2-billion surplus rather than a \$16-billion deficit. Yet most of that shift represents a sharp increase in revenues rather than spending cutbacks -- and for that matter, there is no certainty that Congress will approve the proposed budget-balancing measures. Finally, and most importantly, little has been done to date to cut Federal spending and a likely deficit of \$37 to \$43 billion in the current fiscal year. Despite recent signs of recession, the problem of rampant inflation and sky-high interest rates is still our major concern.

I would argue that the government could make a greater contribution to the anti-inflation fight by restricting spending rather than by boosting revenues. Our elected representatives in Congress should take the lead here. First, they must overhaul the legislative process itself -- especially considering that, in 1979, Congress passed three times as many bills that contributed to inflation as did the reverse, according to a recent study by the National Association of Business Economists. Again, Congress would do well to follow-up on the Congressional Budget Office's list of 58 areas of possible budget cutbacks -- including, for example, the modification of indexing requirements for social-security benefits and other Federal programs, which could yield \$70 billion in savings over a five-year period. (Almost \$40 billion of that total could be saved by granting social-security recipients an 85-percent adjustment instead of a 100-percent adjustment for increases in the consumer price index, which is logical because of the CPI's

tendency to overstate the actual inflation rate.) Such cutbacks are politically difficult to enforce, of course, but they are also essential to our long-term economic health.

Inflation and Monetary Policy

Monetary policy meanwhile has a crucial role to play in restoring price stability, especially in view of the fact that excess money creation helped create the problem, in the wake of the excess credit demands generated by Federal deficit financing and other forces. Over the 1975-79 business expansion, the M-1B measure of the money supply grew at more than a 7-percent annual rate -- faster than in the 1970-74 period, and almost twice as fast as in the less inflationary period of the 1960's. The M-1B measure, incidentally, consists primarily of currency plus demand and other check-type deposits.

The Federal Reserve, recognizing that price stability requires a progressive reduction in money-supply growth, moved aggressively last October 6 to enforce its tight-money policy decisions. In particular, it placed more emphasis on controlling money-supply growth, and placed less emphasis on minimizing short-term fluctuations in interest rates. The early returns are quite heartening. In the six-month period prior to October 6, the M-1B money supply increased at more than a 10-percent rate; in the subsequent six months, the estimated growth rate averaged roughly 6 percent -- which means that at present we are within the 4-to-6 1/2 percent range set by the Fed for 1980. Moreover, according to Chairman Volcker's recent testimony to Congress, the Fed's desired target

growth rate for this measure in 1980 is the midpoint of the 4-to-6 1/2 percent range, implying further deceleration of monetary growth. We're already seeing some results from this policy of monetary discipline, with inflation expectations being squeezed out of the economy, and with interest rates falling sharply from the stratospheric highs reached in the late-winter months. In the past month and a half, for example, Treasury-bill rates have dropped about 5 percentage points, and corporate-bond rates have fallen about 1 1/2 percentage points.

The most heartening recent development in this area was the passage a month ago of legislation which should provide a permanent source of strength to the nation's monetary policy. The legislation goes by the tongue-twisting title of "The Depository Institutions Deregulation and Monetary Control Act of 1980," and despite being almost overlooked in the media, it represents the most important piece of financial legislation of the past generation. It helps to solve the problem of declining Federal Reserve membership, by reducing the cost of reserve requirements for member banks. It helps to support equity and to improve monetary control, by extending reserve requirements to all depository institutions with transactions accounts (check-type accounts) and non-personal time deposits. And it helps to promote greater competition in financial markets, primarily by phasing out deposit interest-rate ceilings and by broadening the asset and payments powers of banks and thrift institutions. The new legislation makes a number of basic structural changes, and in the process, it increases the effectiveness of monetary policy in confronting the inflation problem.

The measures taken on March 14 represent yet another segment of the overall anti-inflation program, with the Federal Reserve broadening its policy of restraint, as a means of spreading the impact of its policies more evenly throughout the credit markets. The consumer-credit restraint program for many lenders and retailers was designed to diminish excess credit demands arising from unsecured loans, but not to discourage worthwhile loans where collateral is involved, such as auto, home-appliance and home-improvement loans. The voluntary credit-restraint program for banks was designed so that banks would limit themselves to productive loans -- especially those for farmers, small businesses and home-builders -- while avoiding acquisition loans and those involving speculation in commodities and inventories. Yet despite this increased attention to lending policy, the Fed will continue to base its credit-restraint program mainly on its control of money-supply growth.

Concluding Remarks

To sum up, my remarks today suggest that strong measures are needed to overcome the new outburst of inflation which has undermined the economy so badly in recent months. The Administration has taken an unprecedented step by re-opening the books on its 1981 budget document only a month and a half after sending it to Congress, with the intention of ending the inflation stimulus created by continued massive Federal deficits. But as I've suggested, much more remains to be done along that line, with increased emphasis on spending cutbacks rather than tax boosts.

The Federal Reserve meanwhile has broadened its policy of restraint, with its March 14 guidelines on various types of lending. Still, these

measures must be considered secondary to the Fed's basic policy of controlling money-supply growth. That policy has begun to show some success in reducing speculative excesses and inflation expectations, as evidenced by recent declines in interest rates. But unfortunately, we cannot expect such an approach to yield immediate results on the price front. History shows that there is an unavoidable lag between the imposition of a program of monetary restraint and the eventual return of price stability. (For example, the inflation rate was cut in half following the 1974 tight-money period, but it took two years' time to accomplish that task.) In any case, it is imperative that we continue to follow this basic cure for inflation, with the steady application of disciplined monetary and fiscal policies.

#