



FEDERAL RESERVE BANK OF SAN FRANCISCO

Office of the President

WHAT FOLLOWS THE RECESSION?

Remarks of

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Meeting with Boise Community Leaders
and Directors, Portland and Salt Lake City Branches,
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What Follows the Recession?

I'm very happy to be back in the Gem State once again, especially at a time when cattle prices are recovering and when silver is selling at more than \$21 an ounce. I'm also glad that Boise's community leaders can have this chance to get together with the directors of our Portland and Salt Lake City offices. Our directors are an able and diverse group of individuals, and they help in many important ways to improve the performance of the Federal Reserve System, the nation's central bank.

Role of Directors

The directors at our five offices are involved with each of the major tasks 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 in particular, the development of monetary policy. We are fortunate in the advice we get from them in each of these areas.

Our directors constantly help us improve the level of central-banking services, in the most cost-effective manner. This is a crucial role at the present time, because under the terms of the new Monetary Control Act, the Federal Reserve is moving into a new operating environment. Over the next year, the Fed's services will be made available to all depository institutions offering transaction (check-type) accounts and nonpersonal time deposits, and those services will be priced explicitly for the first time.

Yet above all, our directors 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 our 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.

Outlook for the Nation

We need their insights now more than ever, because of the vast uncertainty which surrounds the outlook for the year ahead. A growing number of analysts argue that the recovery from the recession is about to begin -- or perhaps has already begun. The record second-quarter decline in real GNP, with the production of goods and services dropping at a 9½-percent annual rate, has been followed by a much stronger set of statistics in the quarter just ended. Industrial production turned around in August, for the first time this year, while housing starts rose throughout the early-summer months. Consumer income scored significant real gains in both July and August. Retail sales correspondingly increased in those two months, and these sales gains contributed to some unwinding of business inventories. Labor-market statistics have shown a high yet relatively stable level of unemployment since last spring, but they've also shown a remarkably high level of employment; at midsummer, more than 58 percent of the adult population had jobs, a figure unmatched except at the 1978-79 peak of the boom.

Of course the economy still isn't out of the woods, especially in view of the still-weakened condition of some of the nation's major

industries. New auto sales, in unit terms, and new housing starts both lagged 22 percent behind their respective year-ago pace during August. Indeed, activity in both the auto and housing markets may not recover much further if the recent upturn in interest rates persists. And that most basic industry of all, agriculture, still has considerable ground to make up, considering the 36-percent drop in real income per farm between the second quarter of 1979 and the second quarter of this year.

On balance, despite the strong signs of improvement, a permanent recovery may not begin until 1981. For example, further sluggishness in business activity can be expected because of the inventory situation. Manufacturers' inventory-sales ratios, in real terms, are close to the highs reached in the last recession, and the excess stocks will have to be brought under control in the period ahead. The business-investment sector may also remain weak. Business capital-spending plans have been reduced in each of the surveys reported so far this year, and the latest survey indicates a decline in real spending during 1980. My research staff has weighed all these factors, and in line with the general consensus, expects growth of 2 percent or more in real GNP over the four quarters of 1981, following a real decline of comparable magnitude during the current year.

Outlook for Idaho?

What does all this mean for Idaho and its \$7-billion economy? Throughout much of the past decade, it sometimes seemed that Idaho would continue to grow despite whatever happened to the national

economy. In reality, however, Idaho has been seriously hurt by the national recession -- for example, with last spring's national housing collapse sharply affecting the state's lumber industry, and the drop in fast-food restaurant sales affecting Idaho's potato market. But the factors that provided the foundation for the boom of the 1970's -- led by the continued in-migration of new people and new industries (such as electronics) -- should generate a greater-than-national uptrend in activity over the period ahead.

Much of the strength should come from a rejuvenated farm sector. Idaho has benefited from good growing and grazing conditions, unlike the drought-stricken Midwest, and the value of its farm marketings should reflect that fact. In the year ahead, beef production may rise only slowly, as cattlemen continue the process of rebuilding their herds, and cattle prices should strengthen accordingly. And although wheat production (despite the drought) may reach a new record this year, the shortage of other grains and the prospective expansion of U.S. and worldwide demand should brighten the prospect for this state's wheat producers as well.

Idaho should benefit also as the nation expands its search for secure sources of industrial materials. The state's silver industry of course is in the forefront of this activity, supplying as it does half of the nation's production. Largely because of silver, the value of the state's mineral production this year may reach twice the level of two years ago. But Idaho ranks with the leaders in a number of other areas, such as lead and zinc, and the current \$600 million of

new mining projects now underway should guarantee the continuation of the state's leadership in the mining industry.

Problem of Inflation

But now let's consider the overriding problem of inflation -- that problem which has undermined the state's and the nation's prosperity so severely in recent years. Inflation must remain uppermost in our minds as we move into the recovery period, because we cannot afford to repeat the mistake we made at the beginning of the last business recovery in the mid-1970's -- adopting unnecessarily stimulative policies which only fueled the flames of later inflation. The nation simply cannot afford the experience of the 1970's, when stimulative policies led to a doubling of prices within a single decade.

The problem lies not just with external price "shocks" -- of which we've had more than our share -- but also with a rising underlying rate of inflation. We're now suffering from our second major oil-price shock, represented by the doubling of OPEC crude-oil prices last year. Moreover, despite the current glut, a rising trend of energy prices can be expected over the longer term, with the gradual depletion of the world's low-cost oil reserves. Food prices are likely to rise sharply in the period immediately ahead, as a result of the severe weather problems affecting food production worldwide. By some estimates, food prices could rise at a 15-percent annual rate over the next year -- double the gain of the past year.

We may not be able to do too much about the shocks affecting food and energy prices, but we can do much more to limit the underlying

inflation rate which affects the other three-fourths of our household budgets. Throughout much of the past decade, the underlying or core rate of inflation was below 6 percent; over the past year, it approached 9 percent. That price upsurge reflected two factors. One was the excessive money growth of past years, when monetary policy was pushed off course by the excess credit demands created by Federal deficit financing and other forces. The price rise also reflected an upsurge in unit labor costs, because of sharp gains in labor compensation and severe declines in the productivity of the nation's workforce. In such an environment, policymakers must guard against overly stimulative policies, which would only aggravate the inflation and undermine the incipient business upturn.

Monetary Policy and Inflation

Monetary policy will have a crucial role to play in the anti-inflation fight, especially in view of the part played by excess money creation in the development of the problem. 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 fall to enforce its anti-inflation policy decisions. To that end, the Fed began to place more emphasis on controlling money-supply growth,

and less emphasis on minimizing short-term fluctuations in interest rates. The policy has been broadly successful, despite major fluctuations around the growth trend. In the six-month period prior to the October 6 policy shift, the M-1B money supply increased at more than a 10-percent annual rate; since that time, however, the money supply has increased at only about a 6-percent rate.

The historical record suggests that any prolonged reduction of money growth will be followed, with a lag of two years or so, by a reduction in the underlying inflation rate. The past year's deceleration in money growth thus should have favorable results for prices, especially if the Fed is successful with its announced policy of bringing about further deceleration in coming years. But a period of sustained price stability cannot be assured until we control those forces which have led to the past record of excessive money creation -- primarily such factors as excessive Federal-deficit spending.

Fiscal Policy and Inflation

No one can deny the close connection between the doubling of prices and the upsurge of deficit financing over the past decade. The combined Federal deficits of the 1970's reached \$315 billion -- about the same as the total of all deficits recorded in the nation's entire earlier history. The Federal government continued to run huge deficits, instead of surpluses as it should, throughout the 1975-79 period -- one of the longest business expansions of the past generation. In the fiscal year just ended, the recession led to a near-record deficit of about \$61 billion. And in the new fiscal year, despite all the earlier talk of

a surplus, we might easily run up at least a \$30-billion deficit -- even if no tax cut is enacted.

Of course, tax-cut proposals are popular today, and not simply because this is an election year. Indeed, without a tax cut, the tax burden on most people would rise significantly in 1981, by more than \$50 billion if present laws remain unchanged. A combination of inflation and a "progressive" income-tax structure could generate an extra \$20 billion in tax revenues. Another \$17 billion is expected from higher social-security taxes, because of the need to pay benefits that rise constantly as a result of being indexed to inflation. And yet another \$15 billion or so is likely to result from the "windfall" profits tax on oil companies.

A good case can be made for tax reductions, first to reduce the tax burden on the nation's people, and secondly to stimulate job-creating and productivity-enhancing business investment. However, I would give equal importance to sharp spending cutbacks, which are essential if we hope to reduce the government sector's excessive demands on the nation's resources. The task won't be easy, especially in view of the bipartisan support for a 25-percent increase in defense spending (in real terms) over the next half-decade. But prudent reductions across a wide range of nondefense programs are both possible and necessary. In this connection, the Congressional Budget Office last spring provided a list of 58 areas which could yield perhaps \$233 billion in budget cutbacks over a five-year period. For example, changes in indexing requirements for social-security benefits and other programs alone could yield \$70 billion in savings.

While reducing Federal spending pressures, we should also try to reduce Federal borrowing pressures in financial markets, with special attention to those activities which are not financed through the budget. Some borrowing pressures arise 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. Altogether, total Federal and Federally-assisted credit demands could reach perhaps \$105 billion in the present calendar year -- almost 30 percent of all credit demands.

In a recession period, heavy Federal borrowing demands may not be overly burdensome. But the situation is quite different in a recovery period, as may already be seen from the recent turnaround in interest rates. As productive resources become pressed by growing private demands for goods and services, the Federal government could preempt the loanable funds needed for financing private capital formation -- and in the process, it could hamper the needed improvement in the nation's productivity while undercutting housing and other interest-rate sensitive industries.

Concluding Remarks

My review of the national and regional outlook suggests that we have some crucial decisions to make in the period immediately ahead. The recession, if not already over, may soon be overcome because of the economy's normal recuperative powers and the "automatic stabilizers" operating through the Federal Budget. But the crucial question is,

"What follows the recession?" The answer can and should be a return to a productive growth path in an atmosphere of relatively stable prices. The alternative is a continued boom-and-bust cycle, with accelerated inflation and an increasingly unstable economy.

Inflation remains our most important problem, and we cannot surmount it without a sustained policy of monetary and fiscal discipline. The Federal Reserve is determined to seek reduced rates of monetary expansion over coming years, to help bring about a return to price stability and stable growth. But the Fed can't accomplish its task without a parallel reduction in Federal spending and Federal borrowing pressures. A coordinated disciplined approach thus is essential to our long-term economic health.

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