



FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

WORKING OUT A SOLUTION

Remarks of

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**Meeting with Los Angeles Community Leaders
and Directors, Los Angeles Branch,
Federal Reserve Bank of San Francisco**

**Los Angeles, California
February 24, 1981**

Working Out a Solution

I'm grateful for this opportunity to meet with the leaders of one of the world's great cities, to discuss with you the steps being taken by our representatives in Washington to work out a solution to the nation's severe economic problems. I for one am glad to see the many forthright measures that are now being adopted to curb inflation. But I'm tempted to add that our problems would not be so severe today if those same measures had been taken much earlier -- as many people in this audience have advocated for years.

Role of Directors

I'd like to pay tribute in this regard to the directors of our Los Angeles office, who have consistently provided us with useful advice on policy problems. Indeed, the directors at all of our five offices have become involved with each of the major tasks delegated by Congress to the Federal Reserve System. 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 become 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 nine-state district and in various sectors of the Western economy. Our directors thus help us anticipate changing trends in the economy, by providing insights into consumer and business behavior which serve as checks against our own analyses of statistical data.

Outlook for the Nation

Their advice is invaluable at the present time, because of the uncertainty of the business climate confronting the new Congress and the new Administration in Washington. One Southern California executive said during the inauguration festivities that President Reagan "would be teeing off in a heck of a headwind." Following through on that golfing analogy, I would add that this competition (unlike the recent Crosby tournament) won't be postponed because of weather; it will have to be played in the teeth of the hostile elements.

At this point, near-term business prospects are hard to gauge, battered as the economy is by the winds of inflation. But there's no doubt that the economy is somewhat stronger today than had been expected six months to a year ago. The turnaround in activity between the second and fourth quarters of 1980 was one of the sharpest in recent history,

and many of the early-1981 statistics indicate continued strength. January's employment and retail-sales figures, for example, suggest that the late-1980 momentum has been maintained, and thus cast doubt on the standard forecast of early-1981 weakness in business activity.

Forecasting indeed is a tough chore at the present time. A case can be made for a continued upturn, based upon the likelihood of substantial tax cuts, the resumption of an inflation-caused "buy now" attitude on the part of consumers, and the growing strength of certain noncyclical sectors of the economy. But a case can also be made for the opposite movement -- a resumption of the aborted recession of mid-1980. Consumer budgets have already been undermined by the inflation-caused bracket creep of income taxes and a new boost in social-security taxes -- middle-income workers, for example, are facing a 24-percent boost in social-security taxes this year. Meanwhile, soaring prices of food and energy are not leaving consumers too much for discretionary purposes, which means continued weakness for the auto and housing industries. In addition, business plant-equipment spending plans appear soft -- not surprisingly, in view of the fact that business firms can't count on getting a reasonable return on their investment in these inflation-scarred times.

When we sort out all these conflicting trends, we're likely to agree (with considerable hedging) that the consensus forecast for a relatively sluggish year is the likeliest outcome. Without doubt, we can expect boom conditions in certain industries, such as energy, defense and office-building construction. Almost as certainly, we can expect at

best a modest recovery in autos, housing and related industries. On balance, this means that real output of goods and services will rise by a small amount during the year, and that pockets of unemployed workers and unemployed machinery will remain scattered throughout the economy.

Outlook for the Region

The outlook for the Los Angeles market is somewhat stronger, as befits the vast size and diversity of this \$125-billion market, which stretches from Palm Springs on the southeast to Santa Barbara on the northwest. (This Australia-sized economy accounts for six percent of the U.S. economy, and for fully one-third of the Western economy.) Despite the region's well-publicized housing problems, it stands to benefit otherwise from its industrial structure, which is concentrated in those sectors (energy and defense spending) which are growing fastest on the national scene. Another obvious source of strength is the office-building boom, which is adding the equivalent of eight Empire State buildings to the L.A. skyline.

Los Angeles appears uniquely qualified to develop answers to the nation's long-term problems, because of its dominance of the high-technology and "knowledge" industries. The region's universities and think tanks, which produce inventions and innovations out of such inputs as human and electronic brains, can claim a large share of the credit for L.A.'s recent growth record. It helps, of course, that the area boasts the largest concentration of Nobel prize winners of any area in the world, plus hundreds of thousands of scientists, engineers and other professionals.

Yet despite that reservoir of talent, even this Sunbelt capital has problems paralleling those of all the other major metropolitan areas in the country. The most obvious problem is the impact of an uncertain inflationary environment on municipal finances. Nationwide, the impact could be measured by a sharp rise in 1980 in financing costs, with the Bond Buyer index of long-term municipal yields rising from 7.4 to 10.1 percent over the course of the year. And municipal financing difficulties seem bound to be aggravated by the interaction of the two key national problems -- severe inflation and massive Federal borrowing demands.

Problem of Inflation

Let's consider the current status of the inflation problem. Inflation, as measured by the consumer price index, doubled within the single decade of the 1970's, and would have doubled again within only a half-decade if the early-1980 pace had been maintained. Over the second half of last year, the inflation pace began to slow down, according to that index. However, the pace continued to accelerate according to the broadest measure of price pressures -- the GNP price index, or deflator -- which rose from 9.5 percent to 10.2 percent between the first and second half of 1980. This evidence, plus the more recent evidence of early 1981, thus indicates a strong reason for policymakers to maintain a tight anti-inflation policy in the months ahead.

The danger is not just the continuation of external price "shocks" -- of which we've had more than our share -- but also the uptrend in the underlying rate of inflation. American households are now suffering from their second major oil-price shock, as evidenced by a two-thirds increase in the energy component of the consumer price index over the past two

years. Moreover, despite the current glut, most energy analysts expect a sharply rising trend of prices over the longer-term, with the gradual depletion of the world's low-cost oil reserves. Food prices meanwhile seem likely to rise substantially this year, as the result of a shift in the cattle cycle and poor growing conditions worldwide. By some estimates, food prices could rise 15 percent over the next year -- almost double the increase of the past year.

Still, food and energy account for only about one-fourth of our household budget, and inflation has worsened in other sectors as well. Throughout most of the past decade, the underlying or core rate of inflation, although accelerating, remained below six percent a year. In the last several years, however, that underlying rate has exceeded nine percent. This upsurge in inflation has gone hand in hand with an upsurge in unit labor costs, because of sharp gains in labor compensation and actual declines in the productivity of the nation's workforce. The cure for that part of the problem is productivity-enhancing tax stimuli, such as those the President has just proposed. But the upsurge in inflation has also gone hand in hand with the excessive money growth of past years, when monetary policy was pushed off course by the excessive credit demands generated primarily by Federal deficit financing. And the cure for that part of the problem is to curb rapid money creation by reducing deficit-financing pressures.

Problem of the Deficit

In an attempt to improve its control over money growth, the Federal Reserve changed its operating techniques in October 1979 -- in effect,

by placing more emphasis on controlling the quantity of bank reserves than on tightly pegging the cost of those reserves (that is, the Federal funds rate). But the Fed was only partially successful in curbing money growth in the face of sharp changes in inflation expectations and wide fluctuations in credit demands. Some critics argue that this occurred because the Fed failed to apply its new operating procedures consistently. Probably a better explanation, however, is the continuation of heavy deficit-financing pressures.

A government deficit can be financed by attracting the savings of the public, or it can be financed by creating money. The latter approach is followed in most underdeveloped countries, because they lack fully-developed capital markets. But most industrial countries, with their highly developed financial markets, are able to channel private savings into purchases of government debt. In this respect, the U.S. has behaved like an underdeveloped country, whereas Germany and Japan have financed their large government deficits through private savings.

Our country, in other words, has failed to break the link between government debt and inflationary money creation as Germany and Japan have done. German and Japanese financial markets have succeeded better than ours in mobilizing private savings to finance government deficits. Over the course of the past decade, U.S. households sharply reduced their savings rate, from $7\frac{1}{2}$ to $5\frac{1}{2}$ percent of disposable income. In contrast, Japanese households consistently saved more than 20 percent of income, and their German counterparts saved between 12 and 15 percent of income. This divergence reflects differences in tax policy and in inflation effects

on savings incentives, which in this country have encouraged consumption rather than savings, and thereby have discouraged productivity-enhancing business investment. Whatever the reason, we must reduce Federal deficit-financing pressures if we want to reduce inflation and encourage domestic saving and investment.

The President's new fiscal program represents an important step in the right direction. It includes personal-income tax cuts and accelerated depreciation write-offs designed to stimulate a long-awaited improvement in productivity-enhancing investment. The program also includes a broad and judicious mixture of spending cuts designed to keep deficits from spiralling and creating even worse pressures on financial markets. The proposed cuts range across a wide range of programs, from food stamps to synthetic-fuel development, from extended unemployment compensation to the space-shuttle program, and from public-service jobs to postal subsidies. Still, the Administration's budget proposals result in large fiscal deficits for the next three years, with no balanced budget in sight until 1984. For the 1981-82 period, the deficits add up to almost \$100 billion. This suggests that Federal demands in credit markets will continue for some time to press upward on borrowing costs -- at a time when the Federal Reserve is committed to an anti-inflation objective of gradually and steadily reducing the growth in monetary stimulus.

Need for Spending Cutbacks

The necessity for substantial spending cutbacks in nondefense programs is obvious, given the Administration's commitment to a defense buildup coupled with tax reductions. Fiscal 1981 admittedly is almost

half-over, but a running start seems necessary to achieve results in the next fiscal year. Incidentally, outlays for fiscal 1981 will exceed earlier estimates by a wide margin, mounting to \$655 billion in the Administration's new estimate -- \$75 billion more than the fiscal-1980 figure and some \$20 billion higher than the figure adopted in last fall's Congressional budget resolution.

In coming budget debates, Congress will have to deal with some politically sensitive entitlements programs -- "payments for individuals" -- simply because that's where the money is. Such payments amounted to 70 percent of total outlays, aside from defense and interest payments, in the last fiscal year. Entitlement programs increased eight-fold over the past decade and a half, and they accounted for virtually all of the real increase in budget spending recorded over that period.

The upsurge in these programs reflects the fact that roughly 90 percent of payments to individuals are now subject to indexation formulas. Indeed, this means further budgetary problems in the years ahead. According to Congressional Budget Office estimates, such payments could be \$192 billion higher in 1985 than in 1980, and roughly three-fourths of that amount will represent the cost of automatic escalation. The problem is compounded by the choice of an inappropriate index -- the consumer price index, which has overstated inflation recently by virtue of the heavy weight it gives to mortgage interest rates and home prices. (Certainly it's inappropriate for those recipients who generally reside in rented quarters or paid-up homes.) Indexing will be expensive in any

case, but a single reform designed to adjust for this overweighting could save \$30 billion over the 1980-85 period alone.

Several uncertainties still surround the Administration's program. The full details of the budget-cut proposals won't be sent to Congress until March 10. In addition, the budget proposals are still just that, since they must still run the Congressional gauntlet. The shape of the final budget package -- specifically, the Federal government's actual financing needs -- will determine the pressures the Federal government will place on the financial markets and the environment in which the Fed will have to conduct monetary policy.

Monetary Implications

Failure to curb Federal deficit spending will have dire consequences -- crowding out private borrowers if the Fed holds to its policy goals, or leading to spiraling inflation if the Fed loosens up and accommodates the Treasury borrowing needs. At present, when efforts to restrain monetary growth confront strong private credit demands, large new Federal borrowings would inevitably aggravate interest-rate pressures. Total Federal and Federally-assisted borrowing in the nation's credit markets approached \$120 billion last year -- roughly 30 percent of all credit demands -- and comparable figures may again be seen in the present period of strengthening credit demands. Indeed, the Treasury will need to raise \$36 billion of new money in the present quarter alone -- one-third more than in the year-ago period.

The credit demands of the Federal government, the nation's prime borrower, definitely will be met. The question is how many other potential

borrowers -- many with more productive uses of money -- will be shouldered aside by market pressures. In that situation, there's a danger that the Fed's restraints on money and credit creation will jeopardize future prospects for business expansion and private job creation. But consider the alternative. If we did not restrain money growth, we could contribute to an inflationary process that would lead to a prolonged period of soaring interest rates.

Concluding Remarks

Chairman Volcker will discuss the policy dilemma facing the Fed in the semi-annual report -- the Humphrey-Hawkins report -- which he will present to Congress tomorrow. Without revealing any numbers, he has already indicated in a recent Congressional appearance that the Fed will continue its policy of gradual reduction in the growth rate of money, because that is a necessary ingredient in a successful effort to bring down the rate of inflation. But I would add that the Fed's policy can be workable only if the Congress and the Administration cooperate by reducing deficit-financing pressures on the credit markets.

If the Federal Reserve hits its money-supply targets and if the Federal debt continues to grow at a rapid rate, we could experience severe upward pressures on interest rates. With the supply of funds constrained by the Fed's tight-money actions, and with the demand for funds rising because of growth in the Federal debt, the price of funds (the interest rate) would rise and crowd interest-sensitive borrowers out of the market. The pressure on the markets could be relieved temporarily if the Fed overshot

its monetary targets, but that would simply postpone any progress in the fight against inflation, and might even worsen the situation. The alternative is to reduce deficit-financing pressures on the market by a major program of spending cutbacks. In other words, the Fed can no longer play the role of "the only game in town" -- fiscal policy also must play a role as the nation works out a solution to its inflation problem.

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