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FEDERAL RESERVE BANK OF SAN FRANCISCO

Office of the President

ECONOMIC PROBLEMS IN 1981

Remarks of

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and Directors, Portland Branch
Federal Reserve Bank of San Francisco

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Economic Problems in 1981

I'm glad to have this opportunity to visit the Northwest once again, to discuss with you the problems facing the national economy and the path that I think we should follow in overcoming those problems. As you well know, inflation and the policy response to that problem have sharply affected many Northwest industries. It's essential that we develop a well-balanced set of fiscal and monetary measures in 1981, so that housing and other interest-rate sensitive industries do not continue to suffer as they have the past several years. Thus, the advice and support of the people in this audience will be very useful to us as we work to develop an effective anti-inflation program for the 1980's.

Role of Directors

I'd like to pay tribute in this regard to the directors of our Portland 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, and 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 West Coast 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 expect 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

As for the regional economy, Oregon's fortunes still depend to a great extent on the housing industry. On the average, the nation's homebuilders produced almost 1.8 million new homes per year in the 1970's--up sharply over the preceding decade--but the industry certainly didn't maintain that average each year of the decade. Building activity declined by half or more in both the 1974-75 and 1979-80 downturns, and the late-1980 recovery only returned the new-starts level to a 1.5-million annual rate. Thus, the industry is operating considerably below the average of the past decade--and considerably below the potential of the 1980's.

This weakness of course reflects the declining fortunes of the home-financing industry, with thrift institutions last year suffering 30-percent reductions in both their deposit inflows and their mortgage-lending activity. But homebuilders nationally, and hence Oregon's forest-products manufacturers, are likely to experience smaller swings in the future, because of the ongoing deregulation of home-financing institutions. Deregulation means that these institutions will have to pay more for funds than in the past--but at the same time, they may be able to utilize new types of mortgage instruments with rates that fluctuate with the market, which would help them reduce their dependence on long-term fixed-price mortgages. Housing therefore should benefit from a more stable flow of funds in coming years.

Oregon meanwhile should continue to benefit from the growing diversity of its economy, which made it possible to hold total employment almost level

last year despite a 17-percent decline in jobs in forest-products manufacturing. For example, employment in electronic firms increased eight percent last year, and continues to look promising today. Strengthening farm prices--helped along by growing national and international demand for Oregon's wheat and other products--should help offset rising farm costs this year. Another plus, of course, is Oregon's continuing population growth, which represents a welcome boost to consumer demand as well as increased representation in Congress.

Problem of Inflation

Still, Oregon's health depends on how well we deal with inflation. 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. Since that time the inflation rate has trended downward, according to the consumer 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 January's sharp increase in producer prices, 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 (or non-shock) 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, this underlying or core rate of inflation, although accelerating, remained below six percent a year. In the last several years, however, the 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 for three successive years, 1978-1980. 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 last year 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 more like an underdeveloped country, whereas Germany and Japan have financed their large government deficits mainly 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 7½ to 5½ 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, social programs, regulatory policies, and differences in the way inflation affects savings incentives. Because of these differences, U.S. policies have boosted consumption and reduced savings, and have discouraged productivity-enhancing capital investment. Whatever the reason, we must reduce Federal deficit-financing pressures and change tax and regulatory policies 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 addition to cutbacks in business subsidies and other programs, Congress in coming budget debates will have to turn its attention to some politically sensitive entitlement programs -- "payments for individuals" -- simply because that's where the money is. Aside from defense and interest costs, such payments amounted to 70 percent of other outlays 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 inflation-adjusted 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.

In this difficult situation, the Federal Reserve has no choice except to continue with its policy of reducing money-supply growth gradually over time, to help the national economy return to a non-inflationary growth path. This was the gist of the message provided by Chairman Volcker in his

several Congressional appearances over the past week. As he noted, the Fed has set a target growth range of 3½ to 6 percent this year in the M-1B measure of the money supply, compared with the 6 3/4-percent growth in that aggregate over the past year -- all abstracting from shifts that will be caused by the growth of NOW accounts. M-1B, incidentally, consists primarily of currency and transaction (check-type) deposits at depository institutions.

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

To sum up, the outlook appears definitely mixed for both the regional and national economies -- and it will remain mixed as long as inflation persists. The nation is in the midst of an unremitting fight against inflation, and some restrictiveness is inherent in the gradual reduction of money growth over time. But with this approach, as Chairman Volcker noted in his Congressional testimony last week, the stage will be set for stronger real growth in the economy as inflation begins noticeably to abate.

There's no doubt that we face a policy dilemma in 1981. If the Fed hits its money-supply targets and if the Federal debt continues to grow at a rapid pace, we could experience severe upward pressures on interest rates. With the supply of funds constrained by the Fed's policy actions, and with the demand for funds rising because of Government borrowing requirements, the price of funds (the interest rate) would rise and crowd housing and other interest-rate 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, fiscal policy must supplement monetary policy to hasten the nation's return to a non-inflationary growth path.

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