

THE IMPACT OF NATIONAL ECONOMIC POLICIES UPON THE PACIFIC NORTHWEST

REMARKS BY

John J. Balles

PRESIDENT
FEDERAL RESERVE BANK
OF SAN FRANCISCO

Federal Reserve Bank
of San Francisco
Seventh Annual Meeting
Pacific Northwest
Regional Economic Conference
Portland, Oregon
April 26, 1973

NOV 5 1975

LIBRARY

H62567
S3A2
4/26/73



John J. Balles

When your program chairman invited me to address this conference he expressed frustration over the fact that developments in the Pacific Northwest, as reported in Federal Reserve studies, often are lost in the geographic enormity of the Twelfth Federal Reserve District and in statistics which are dominated by developments in California's economy. Therefore, I am especially pleased to have this opportunity to discuss the impact of a number of national economic policy issues on the Pacific Northwest.

The Twelfth Reserve District is the largest geographically—covering seven states west of the Rockies along with Alaska and Hawaii—and by far the most diversified. Because of this diversity, we attempt to follow developments in individual regions of the District as closely as possible, paying particular attention to those sectors of

economic activity which exert a strong influence upon national developments, or which are strongly influenced by national developments. In this connection, we publish numerous economic data by state and local area in our **Western Economic Indicators**. We, of course, also avail ourselves of the many commentaries and analyses which emanate from the business community and the various entities of the public sector in formulating our assessment of regional developments. With your indulgence, I would like to draw upon these various sources of information to briefly review developments which have shaped the structure of this region's economy.

The Growth of the Pacific Northwest

The Pacific Northwest—generally considered to consist of Washington, Oregon, and Idaho—owed its early growth and development to a rich endowment of natural resources which provided the basis for an export economy. This economy has evolved from complete dependence on the resources of the land and sea, to a diversified structure with an important stake in technological skills. For example, the water resources and power projects of the 1930's paved the way for electro-process industries which now are key elements of your industrial base.

World War II provided a powerful impetus towards expansion and diversification, as the shipbuilding and aircraft industries experienced an unprecedented growth; and in the decades since the war the industrial base has continued to broaden. Although agriculture and forest products still are the primary sources of employment and income in the Pacific Northwest, the manufacturing, services, finance, trade and government sectors have grown rapidly. The ratio of non-manufacturing to manufacturing pay-

roll employment in this area today is 3.7 compared with 2.8 in 1960. The present ratio is similar to that in California and exceeds the national average. Within the manufacturing sector the most impressive growth—and subsequent contraction—of course had been in aerospace. Indeed, the decline in **total** civilian employment during the aerospace slump in Washington during 1968-71—though relatively small—suggests that the region still has a ways to go to achieve a truly “balanced economy.”

Looking Up

Last year was a very good year for the Pacific Northwest. Although recovery and expansion in several cases occurred from a relatively low base, activity in many key areas—including employment, personal income, farm receipts, most categories of construction, and bank lending—scored gains that matched, or exceeded, those in the rest of the Twelfth District and the nation as a whole.

To a considerable extent, this favorable growth resulted from strong external demand for the products of the Pacific Northwest economy. This demand includes a rising volume of both domestic and foreign orders for commercial aircraft, increased orders from the military, the expansion of foreign markets for agricultural products, and the heavy demand for forest products to support the national housing and construction boom. The latter, I might add, represents one of the many important links between the Pacific Northwest and the rest of the Twelfth District. With the exception of Washington, home-building and virtually every major category of construction activity rose in every Twelfth District state last year—in several cases to record levels—and thereby provided a major element of support to the forest products industry.

Further Diversification Needed

The nature of the recent expansion illustrates the fact that a strong national economy presently is the best guarantee of a prosperous Pacific Northwest. The current expansion of your region's economy, though broadly based, still is centered primarily in industries and sectors which are subject to substantial fluctuations. Although it is indeed encouraging that diversification is taking place (and not least of all in the aerospace industry itself) the degree of dependence upon a limited number of sectors remains considerable. Just three sectors—forest products, aerospace and the Federal government (both civilian and military)—account for 17 percent of total non-agricultural payroll employment in the Pacific Northwest. This is a substantial improvement from the 21 percent of non-agricultural employment which these sectors represented a decade ago, but still is almost double the proportion they represent nationally. The proportion also is somewhat higher than in California where the aerospace industry underwent a contraction that entailed the elimination of over 180,000 jobs between 1967 and 1971. The level of aerospace employment in California still is a considerably higher proportion of total manufacturing employment (30 percent) than in Washington (20 percent), or the Pacific Northwest as a whole (13 percent). What is significant, however, is that the heavy dependence on just one sector—aerospace—in California, is more than offset by a relatively greater degree of diversification in other sectors of manufacturing and non-manufacturing activity.

In any event, so long as a regional economy remains heavily dependent upon a very few industries or sectors, its vulnerability to periodic contractions will remain large. This

is especially true if the sectors of dependence are susceptible to either shifts in demand, or to the influence of policy changes at the national level. This vulnerability has prompted questions from time to time regarding the feasibility of regionally-oriented fiscal and monetary policies to assist economically depressed or lagging regions, and it is to this question that I now would like to turn my attention.

A Regionally Oriented Federal Fiscal Policy?

Examples abound of efforts to assist areas experiencing economic difficulties through various support programs of the Federal government. These efforts range from highway construction, to unemployment compensation and food stamps. Indeed, income maintenance programs assisted Washington through its difficulties in 1968-71. In some cases compensatory programs even have been designed to ameliorate difficulties caused by cutbacks in other Federal programs.

The experience of the last few years has demonstrated, however, that heavy dependence upon any form of Federal expenditures is not without its risks. Priorities change—as they even now are changing—and these changes entail the reduction, elimination or reallocation of financial assistance. While I cannot pretend to guess the outcome of current efforts to evaluate and revamp Federal spending programs, it is certain some change of this sort will be involved.

One would hope that the present re-examination of Federal expenditures will produce not only a rationalization of existing programs, but also the

conceptualization of a national balanced growth policy. By "balanced" I mean the types and kinds of growth that are desirable on the basis of economic, social and ecological criteria, and balanced in terms of how much and what kind of growth is appropriate for specific regions of our land. No such policy presently exists, although forces are at work which are certain to keep efforts in this direction, and the issues which they generate, very much alive. I will return to a consideration of some of these forces presently.

A Regionally Oriented Monetary Policy?

Questions also have been asked from time to time regarding the desirability of tailoring some of the tools in the kit of monetary control devices to meet the economic needs of particular regions. Examples which come to mind include "term lending" through the discount window of the Federal Reserve Banks, as well as preferential discount rates and reserve requirements for member banks in areas of lagging economic growth.

On the face of it, proposals such as these may seem to have merit. It is argued, for example, that making loanable funds available on preferential terms to banks in areas experiencing economic difficulties would enable banks to make more funds available at reduced cost to consumers, households and local governments, thereby inducing increased spending, investment and employment. However, the problems involved in this approach are formidable, and it is by no means certain that the desired results would be forthcoming.

First, there is the question of what criteria to use to determine whether banks in a given area should have their supply (or potential supply) of loanable funds

increased. One suggested criterion is a higher than average unemployment rate in an area over a given period of time—say six months. On that basis, 7 of the 9 states in the Twelfth Federal Reserve District—including California—would have qualified for special treatment during the last year. Add up all the states and all the local economies experiencing higher than average unemployment rates, and you have a very large number of claimants for special treatment by the monetary authorities. It is doubtful whether monetary policy could operate effectively under such a constraint, since the spatial allocation of credit would require substantial offsetting open-market operations if national monetary policy objectives are to be achieved.

Secondly, it is uncertain whether efforts to supply more credit to local borrowers in specific regions would in fact be successful. Financial assets are fungible, and it would be difficult to ensure that new funds acquired by banks receiving preferential treatment would not wind up in out-of-state or out-of-region investments, rather than in loans to local businesses and households. Again, the larger open-market sales of securities that would have to be undertaken to offset the increase in reserves provided locally would itself tend to push-up market interest rates and this, in turn, would tend to draw off funds from the areas allegedly benefitting from preferential reserve requirements and discount rates.

Finally, the proposition that an appointed body, such as the Board of Governors of the Federal Reserve System, should be making the type of policy decisions implied by regional or sectoral allocation of loanable funds, is subject to serious question. Such activities would enmesh

the System in a host of political and socio-economic decisions which are the primary responsibility of the U.S. Congress.

Moreover, local "fine tuning" in the form of spatial allocation of credit would make the basic charge of the Central Bank—that is, the formulation and implementation of national monetary policy—more difficult, if not impossible. Each departure from national policy undertaken on behalf of a particular region would require an offsetting action in national money markets to preserve any semblance of monetary control.

Local Responsibility

In light of these considerations, it appears to me that primary responsibility for determining the nature and extent of your region's economic growth, developing and managing its resources, and diversifying its industrial base, rests primarily with those who have the greatest stake in these activities—namely your local business and financial communities. The specification of growth objectives involves major inputs from government and the general public, but the degree to which these objectives can be realized ultimately will depend upon their successful implementation by the private business community operating within established guidelines. Individual Federal programs will, no doubt, provide a major stimulus to the regional economy from time to time, but such programs are transitory and are no substitute for a well-diversified economic base, founded upon local resources and expertise, and oriented toward a broad national and international market. Of necessity, this economic base will be primarily of your own making.

What About Homebuilding?

Having said this, I would hasten to add that in regard to one key sector—home-

building—which has been an important factor contributing to the recent economic expansion in the Pacific Northwest, the Board of Governors of the Federal Reserve System has suggested a number of specific measures to moderate cyclical fluctuations in the industry. For reasons which generally are well recognized, housing activity is particularly sensitive to fluctuations in interest rates and the terms on which mortgage funds are available. Some Board proposals have been designed to limit such fluctuations through structural changes in the market. Other proposals have suggested greater reliance on fiscal policy in the fight to control inflation and maintain a stable economy, thereby relieving some of the heavy pressure on monetary policy.

A key fiscal proposal would authorize the President to alter the business-investment tax credit within a specified range—perhaps from zero to 15 percent—so as to dampen business-spending demand during inflationary periods and accelerate demand during business slowdowns. The Board underlined the importance of the variable tax credit, in view of the fact that the business sector plays a dominant role in the credit competition during tight-money periods which tends to create shortages of housing funds. Other proposals, all designed to smooth out the fluctuations in the flow of savings and mortgage funds, include the eventual removal of interest-rate ceilings on consumer time-and-savings deposits, the lifting of state usury ceilings, the removal of interest-rate ceilings on government-backed loans, and the utilization of variable rates on mortgages.

All of these measures are designed to smooth, not eliminate, the cyclical flow of

funds to housing, and most of them require action at the national level. Some measures—including the key proposal, a variable investment tax credit—require Congressional approval. Skillful use of a nationally oriented set of anti-inflationary weapons—fiscal and monetary—will be necessary to smooth fluctuations in the mortgage market and, hence, fluctuations in the flow of orders into the Northwest's lumber industry.

Changing Social Values—Implications for Pacific Northwest

Next I would like to note a fundamental force for change which is certain to have a very important bearing upon the nature and the extent of economic growth—regionally and nationally. To an increasing degree, the American people are questioning whether traditional economic goals of high and rising levels of income, output, and consumption are consistent with environmental and ecological balance. This question, in fact, has become a national policy issue, but it is more than that. The great debate over the environment is not confined to any particular region, or even to the United States, but rather is global in its dimensions. It is evidenced in warnings from the "Club of Rome" and in the fact that recently Japan has formalized a \$1 trillion effort to clean up pollution, redeploy industry, and revamp its national planning goals.

Here in the United States the problems of growth and the environment are becoming more complex every day; our very success in achieving growth and a standard of living which is matched by few other nations has brought us to the threshold of an energy crisis which itself is inextricably bound to the question of environmental and ecological balance. With 6 percent of the

world's population, the U.S. presently accounts for 35 percent of the world's energy consumption, and at present rates of increase in demand, energy requirements would triple in the next 25 years according to the U.S. Department of the Interior. Yet, every major link in the energy chain, from exploration and extraction of fuel reserves to the consumption and disposal of residuals, is potentially damaging to the environment.

The outcome of the growing debate over growth, energy and the environment is not certain, and it may be some time before a workable consensus emerges. If environmental concerns become more pervasive, then types of activity which involve the heavy throughput of materials—such as construction—may well be viewed with less favor, with obvious adverse implications for the forest product industries of the Pacific Northwest. At the same time, shifts in social values—including the increase in leisure which has been made possible by rising incomes—will redound to the advantage of those areas that are uniquely equipped to orient more of their growth towards recreation and tourism. In this particular respect I would guess that the Pacific Northwest is exceptionally well equipped to harmonize growth with its magnificent environmental endowments.

“No Growth” is No Answer

One course of action, however, would appear to be out of the question—namely, no growth at all. As former CEA head Walter Heller has noted, just imagine the tensions that would develop between various groups in our society if even the minimum demands of the disadvantaged had to be accommodated out of a “no growth” income. What is equally important, a very heavy investment and large income

is going to be required to develop the new equipment which itself will be necessary to develop new and more efficient sources of energy and to clean up the environment. The Environmental Protection Agency finds, for example, that the nation's pulp and paper mills alone will require \$3.3 billion in capital expenditures over a half-decade to bring their operations into compliance with existing water and air pollution regulations.

The Northwest's forest-products industry over the years has made some progress in pollution control by creating more and more products from its own waste materials. Today, about 70 percent of the input into pulp and paper mills consists of residues salvaged after the production of lumber and plywood. The sawdust, shavings and trimmings generated by sawmills—most of which would be burned or emptied into waterways—are instead recycled to produce paper, hardboard, roofing materials, soil conditioners, chemicals and a wide range of other materials.

Yet the forest products industry still faces a mammoth cleanup task, more costly than that of any other industry except steel and the utilities. Some marginal facilities probably will close rather than install costly anti-pollution equipment, and their closings will create economic hardship in some communities dependent on the industry. Nationwide, perhaps 16,000 jobs could be affected by these closings over the next several years.

Environmental-control measures thus will have a strong regional impact, and yet the basic decisions on these measures will be made at the national level. For the most part, it is the Congress that will decide on the tax and subsidy arrangements needed to finance pollution control, and that will

set the guidelines for control standards and for retraining workers affected by the tighter standards. At the same time, regional industries will participate in the process of building into the price of each product its full social cost.

Summary and Conclusion

To summarize and conclude, I have attempted to assess the significant features of the Pacific Northwest's economy. I have noted that, while recent gains in economic activity have been broadly based, your regional economy is still heavily dependent upon industries that are subject to substantial fluctuations in demand, and to policy changes at the national level. Just three sectors—forest products, aerospace and the Federal government—still account for 17 percent of total non-agricultural payroll employment. Further diversification of the industrial base clearly is needed to achieve greater stability in income and employment in this region.

The susceptibility of the Pacific Northwest to large economic fluctuations has raised questions from time to time regarding the feasibility of regionally-oriented fiscal and monetary policies. I have noted that, while the conceptualization of a national balanced growth policy may emerge from present efforts to rationalize existing Federal spending programs, the problems attendant to the implementation of regionally-oriented policies are formidable. This region would be ill-advised to pin its hopes for diversification upon regionally-oriented national policies. Monetary policy, by its very nature, must be national in scope, and fiscal policy is subject to major revision and redirection as national priorities undergo continual evolution. This places the responsibility for diversification primarily on the shoulders of those who have the

Faint, illegible text, likely bleed-through from the reverse side of the page.

