1978 PROSPECTS . . BUSINESS AND THE DOLLAR

REMARKS OF

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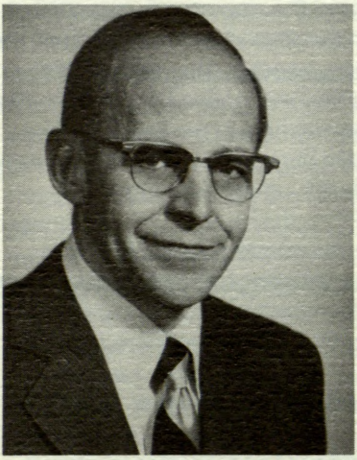
Bankers Club

San Francisco, California
February 1, 1978



Mr. Balles argues that the large U.S. trade deficit was only one element in the late-1977 decline in the value of the dollar. A more important factor was a shift in market sentiment concerning this nation's ability to contain inflation, as reflected in a slowdown in capital inflows into the U.S. For international as well as domestic reasons, therefore, U.S. policymakers must redouble their efforts to combat inflation. We must moderate the growth in our domestic money supply, but in addition, we must adopt an effective energy program to reduce oil-import demand, and also work to offset the impact of those legislative actions that tend to boost business costs and lead to higher prices.

I'm glad to have the opportunity to participate today in that important seasonal ritual, the annual business forecast. The annual pattern, as you may have noticed, is similar to that of the rainy season here in the Bay Area. The season typically begins in late October or early November, builds up considerably in December, and then the heavens open in January. This leads to the question—why have we had so many conflicting forecasts (and so much rain) in the past month or two? The answer is simple—the economic atmosphere (like the meteorological atmosphere) has become quite disturbed during this period.

People would have taken an intense interest in the business outlook this year anyway, because of the fear of impending recession as a result of the rather advanced age of this three-year-old expansion. (I hasten to add, however, that gerontological explanations of the business cycle are somewhat oversimplified; business expansions don't just die of old age, but rather because of riotous living during their earlier stages.) In any event, the already murky economic atmosphere has suddenly become more uncertain because of the clouds drifting across the Pacific from Japan. This development reminds us, not for the first time, that our domestic actions or inactions can eventually create trouble for ourselves through the influence of world market forces.

The forecast pessimists thus may have a point in warning us about all the dangers that face us in 1978. Their advice might be discounted, however, because they badly underestimated the strength exhibited by the national economy over the past three years. In 1977, for example, this $2-trillion economy continued to sustain one of the strongest and most prolonged expansions of the past generation.

Total production of goods and services, in real terms, increased 4.9 percent, and this second straight larger-than-normal increase brought into play more of the reserves of labor and capital that had been left unemployed by the 1974–75 recession. The jobless rate dropped sharply to the lowest level of the past three years. More importantly, employment increased faster than in any other year since World War II—up 4.1 million over the year—and 58 percent of the working-age population held jobs at year-end.

Pattern of 1978 Growth

The consensus forecast suggests a deceleration of activity in the second half of 1978, similar to what we encountered in each of the past two years. The same basic factor seems to be involved—a series of mini-inventory cycles. Businessmen have shown some reluctance to hold large inventories, causing sudden depletion of stocks whenever unexpected developments occurred, such as strikes or sharp increases in final demand (as in the last two Christmas seasons). The result thus has been several first-quarter flurries in stockroom activity, followed by slowdowns in the later quarters of each year. The same pattern could easily be repeated during 1978. But for the year as a whole, total real output may increase about 4½-percent above its 1977 average. Thus the economy would still be growing above its long-run potential, calculated in terms of a steadily growing and more efficient workforce.

Aside from this shifting pattern of inventories, 1978 may witness a mixed pattern of spending in other sectors of the economy. Consumer auto demand may decline somewhat, because of buyers' disinterest in scaled-down models with scaled-up sticker prices. Also, single-family home construction could retreat from its record 1977 pace, as mortgage-lending institutions adjust to the recent slowdown in savings flows. In contrast, business spending for plant and equipment could show unexpected strength, especially in view of the near-capacity levels of operation evident in many industries. Spending by state and local governments should grow, bolstered by Federal grants and by the expanding economy's boost to tax revenues. (In fact, state-local governments moved into a strong surplus position in 1977 even while boosting their spending.) Again, defense spending seems more expansive in terms of the growth of military prime-contract awards, which are running roughly one-fifth above a year ago. On balance, we might expect continued growth but a change in the character of the expansion, with a slowdown by the fast-growing sectors of 1977 (such as consumption), but a speed-up by some of the former slow-growing sectors.

Unemployment and Inflation

Now, most forecasters had argued earlier that continued growth would cause the unemployment rate to drop to about 6½ percent of the labor force sometime in 1978. Well, we've seen that rate achieved already by the end of 1977, and the likelihood now is that the jobless rate will fall to 6 percent or possibly lower later this year. Many observers believe that that figure represents a significant amount of unused resources in the economy. But they may be wrong, because the published jobless rate (for a number of demographic and other reasons) is a much poorer guide in this respect than it used to be. The pressures already reached in the labor market can be measured by the fact that the volume of help-wanted advertising jumped one-third over the course of the past year. And as I've already said, a record 58 percent of the entire working-age population held jobs at year-end, which suggests a closer approach to "full employment" than was achieved in all those years of the past several decades that boasted lower jobless rates.

We might also expect inflationary pressures to continue in 1978. Most analysts would agree that a 6-percent rate of inflation has become imbedded in the overall economy, judging either from the past year's trend of prices, or the increases in wage costs incurred by major pattern-setting industries, or the amount of past fiscal and monetary stimulus. Moreover, we might see further price pressures from a depreciating dollar, reflecting the much higher cost of goods from Japan, Germany and other trading partners.

Trade and the Dollar

This prospect for domestic markets—continued moderate growth, along with continued wage and price pressures—is bound to be affected during 1978 by what happens in the foreign-exchange markets. This forces us to take our eyes off domestic goals and search for answers to the question of "Why did the dollar fall so sharply in 1977?" Actually, the crisis was a relatively recent event. For most of the first three quarters of 1977 (except July), the dollar remained fairly stable in relation to a trade-weighted basket of currencies. But from late September on, the dollar declined steeply and steadily against almost all major currencies except the Canadian dollar—11 percent against the German mark, the Japanese yen, and the British pound, and even more against the Swiss franc. The market then stabilized in early January, when the Federal Reserve and the Treasury undertook support operations in the market and the Fed underscored this move with a half-point rise in its discount rate.

Now, the first explanation—although only a partial one—of the steeply falling dollar can be found in the rapid deterioration in our trade balance with the rest of the world. The numbers here are instructive. The merchandise-trade balance shifted from a $9-billion surplus in 1975 to a $6-billion deficit in 1976 and then finally to almost a $27-billion deficit in 1977. The current-account balance—that is, the balance on trade, services and investment income—deteriorated from a $12-billion surplus in 1975 to a slight deficit in 1976 and then to a $17-billion deficit in 1977.

At least part of the deterioration in the merchandise-trade balance can be blamed upon other things besides oil. Imports of other products—such as autos, steel, radios, TV sets and the like—amounted to about $105 billion last year, or 48 percent above the 1975 figure. In contrast, U.S. exports last year were only about 14 percent above the level of two years before. Our export performance might improve if overseas economies increase their growth rates and increase their demand for American products, while our own surging demand for German and Japanese products should be curbed by a depreciation-caused rise in their pricetags. Imported oil is a separate question, however, and I'd like to digress for a minute to talk about its overall impact on our economy.

Over the past half-decade, oil imports have jumped from $5 billion a year in value to about $45 billion a year, reflecting sharp increases in both the volume and the price of OPEC oil shipments. In this connection, we tend to understate the problem by continuing to refer to the OPEC's four-fold boost in oil prices at the time of the Middle East war, because oil prices in 1978 (even without a price increase) are roughly eight times higher than they were at the beginning of the decade. That date of 1970 is a crucial one, because that's when a "quiet revolution" (in Alan Greenspan's phrase) took place in the world oil market. Prior to that time, the U.S. was the marginal supplier in the market, being prepared to unload Texas crude to keep the price down in any crisis—as in fact it did during the several earlier Middle East wars. But after about 1970, the U.S. could no longer play the same role because of its declining production and still-rising demand, and the key price decisions thenceforth were made by the cartel rather than by ourselves.

Asset Demand on the Dollar

As I said earlier, the large U.S. trade deficit was one element in explaining the decline in the international value of the dollar. However, it was by no means the only or even the major factor in that development. This can be clearly seen from the fact that in 1975, when the U.S. had a $9-billion trade *surplus,* the international value of the dollar was even lower than now, yet in 1976 and the first half of 1977, the value of the dollar actually increased while the trade balance deteriorated. The reason for this was an offsetting and very substantial capital inflow, associated with the high degree of foreign confidence in U.S. political and economic stability—including its price stability.

Even so, asset demand can change very quickly as market sentiments become altered. And in view of the massive size of the holdings of international financial assets, any shift in asset preference can have an enormous impact on the exchange markets, as we have learned so well in the past several months. But what caused the shift in asset demand? We can't simply point to the upsurge in U.S. purchases of oil and other foreign products, because the trade balance had been deteriorating on that account for several years previously.

A more likely explanation has to do with the rise in inflation expectations in the U.S., relative to other major industrial nations. Given its unique role, the dollar is especially sensitive to changes in inflation expectations, because its value as an international store of value and medium of exchange depends heavily on its stability and negotiability. Inflation expectations may have changed because in the 1976–77 period, monetary growth accelerated in the U.S. compared with the previous two years, whereas a number of our major trading partners did not show such a trend, or in some cases, actually displayed decelerating monetary growth vis-a-vis the 1974–75 period. In the short run, this has meant that the U.S. economy has grown more rapidly than the Japanese and European economies. However, it has also suggested the possibility of a worsening of inflationary pressures in the U.S., relative to other major countries.

This experience demonstrates once again that exchange stability in our interdependent world economy is not consistent with divergent monetary policies. Yet divergent monetary policies are virtually inevitable, given the fact that all industrial countries mainly conduct their policies with a view toward their own domestic problems. Thus, so long as such divergence exists, all concerned may be forced to accept the exchange-rate consequences of their policies. Large-scale attempts to target exchange rates or to limit their variations could require continuous exchange-market interventions—which are but another form of open-market operations—and thus could undermine domestic monetary-policy objectives. The Bank of England learned this last fall, when after absorbing an enormous capital inflow, it was finally forced to abandon its effort to hold down the sterling exchange rate against the dollar.

Domestic and International Policy
This discussion finally brings us back to the necessarily close relationship between domestic and international policy. If we want to halt the decline in the dollar and control the turmoil in the foreign-exchange market, we must moderate the growth in our domestic money supply—but we must do much else besides. Several modest interim steps that have already been taken in the foreign-exchange field could help in this regard by attracting a larger flow of capital into the U.S. I'm thinking of such developments as the small rise in short-term interest rates that we have recently experienced, as well as the more active intervention by the Treasury and the Federal Reserve to head off disorderly conditions in the market.

However, an overall solution of that problem will depend on some more basic corrective actions. First would be an effective anti-inflation policy on the part of the U.S. Government. This would include a moderation of monetary growth by the Fed, but it would also need to encompass a moderation or even reversal of those legislative initiatives that tend to work against our national goal of price stability. The checklist of actions which have pushed up costs and prices in the U.S. would include farm price-support legislation, minimum-wage laws, legislative floors under construction-labor costs, maritime subsidies, rail- and truck-transport restrictions, and the various protectionist measures that have been taken to shore up individual industries.

Another basic requirement is the passage of an energy bill that would include effective provisions to conserve oil on a large scale and to stimulate domestic exploration and production—thus reducing oil imports. Also needed is a change in our tax laws to stimulate both direct and financial investment by foreigners in this country. At the same time, our major trading partners could help redress the U.S. trade balance and enhance the foreign value of the dollar if they followed policies aimed at faster economic growth.

Monetary policy of course has a role to play in curbing the decline in the dollar and in curbing inflationary pressures here at home. During 1977, monetary growth was on the high side—about 7½ percent for M_1 (currency plus bank demand deposits) and about 9½ percent for M_2 (currency plus all bank deposits except large CD's). This exceeded the twelve-month growth range that the Federal Open Market Committee had set one year earlier as being prudent for M_1, and was high in the range for M_2. Moreover, inflationary pressures have been aggravated for more than a decade by excessive growth of the monetary aggregates, related in turn to the long series of Federal budget deficits incurred over that period. Ballooning expenditures for a host of Federal programs, even in the face of sharp increases in tax revenues, have caused a cumulative deficit of $337 billion over the past decade and a half.

Deficit spending has worked to pull monetary policy off course in an expansionary direction, by supporting excessive growth of money and credit. This happens because the rise in total credit demands, swelled by large-scale Federal borrowing at a time of rising private-credit demands, tends to force up interest rates. Higher rates then undermine the strength of certain vulnerable sectors of the economy, such as small business, agriculture, housing, and state and local governments. Under pressure to minimize this type of impact, the Federal Reserve has occasionally delayed taking firm action to head off excessive money-and-credit growth, and the eventual result has been more inflation.

Domestically as well as internationally, the best monetary-policy prescription today is to pursue a gradual reduction in the growth rates of the monetary aggregates, to a level consistent with long-run price stability. This is the course on which the Fed set out in March 1975, when it began the practice of making quarterly reports to Congress regarding our targets for monetary growth over the year ahead. During the course of 1977, the Fed lowered the M_1 growth range to the area of 4 to 6½ percent, and the M_2 growth range to the area of 6½ to 9 percent—and despite problems earlier in the year, it kept the growth of the aggregates within those ranges during the final months of 1977. Nonetheless, the central bank will not have an enviable task in the year ahead, because projected Federal deficit spending of $60 billion or so in both fiscal 1978 and fiscal 1979 could create severe new financing demands.

Concluding Remarks

To sum up, we appear to be heading into a year of continued growth but also a year of great potential danger. The greatest danger, of course, is resurgent inflation. If prices should accelerate, and if the Fed should attempt to tighten credit, "crowding out" might become a reality rather than only a distant threat to the financial market. In that case, Treasury financing demands could dominate the market and deny credit to the housing industry and other vulnerable sectors of the economy. Alternatively, if the Fed should try to accommodate all credit demands in this inflationary atmosphere, the result might be another bulge in the money supply and a further boost to inflation expectations—which could then be curbed only by the slamming of brakes and a severe recession. And now that we've been warned by a shot across the bow from the foreign-exchange market, any resurgence of domestic inflation could lead to a severe and lasting deterioration in the value of the dollar, which in turn could give another push to the vicious spiral of inflation.

During the past three years, we've avoided a number of disaster scenarios that were written at the bottom of the recession, and we should be able to avoid this disaster scenario also. To accomplish that goal, however, we must maintain a large measure of discipline in our fiscal and monetary policymaking. Among other things, that requires maintaining the independence of the Federal Reserve within the structure of the Federal government. Over the decades, we in the Fed have been able to make prompt and (if need be) frequent changes in monetary policy, in contrast to the necessarily ponderous processes of fiscal policy. We've also been able to make the hard decisions that might be avoided by decision-makers subject to the day-to-day pressures of political life. A number of such decisions may have to be made in the years ahead, but that is the price required for sustaining a period of domestic and international prosperity into the 1980's.