ECONOMIC STABILIZATION TODAY

REMARKS OF

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

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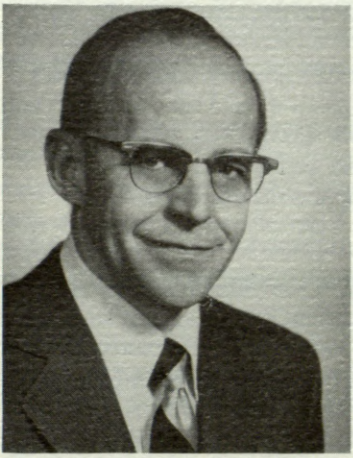

Mr. Balles argues that inflation threatens to undermine the continuation of a strong business expansion. The problem can be attributed largely to the overstimulus achieved through massive Federal budget deficits, which in turn have created pressures on the Federal Reserve to ensure the financing of those deficits. At this stage of the business cycle, the nation should be moving rapidly toward a budget balance or even a surplus, primarily by bringing spending under control. (Instead, Congress voted recently for a sharp 10-percent increase, to $499 billion, in fiscal 1979 spending.) Controlling inflation requires a joint effort on the part of all sectors of the economy. The Federal Reserve cannot do the job alone through credit-tightening policies.

I'm grateful for this opportunity to discuss the state of the economy with the leaders of one of the world's greatest urban centers. I am especially pleased that I can meet with you today under the sponsorship of the Board of Directors of our Los Angeles office—an extremely able and diverse group of individuals.

I'd like to bring to your attention some problems of economic stabilization, at a time when the economy stands at a vital crossroad. But before I begin, I would like to spend a few moments reviewing the important role performed by directors of a Federal Reserve Bank, which is unique among the central banks of the world. Only in the United States does the nation's central bank benefit from a "grassroots" input to policy. Our directors are concerned with each of the four major jobs delegated by Congress to the Federal Reserve—that is, 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 above all, the development of monetary policy. We are fortunate in the advice we get from our directors in each of these areas.

The value of their advice is given greater weight by the diversity of the occupations and groups which they represent. We have consistently obtained the services of a wide range of very competent businessmen, bankers, academicians and agriculturists. But in addition, I'm proud of the fact that, among our five offices, our District has been the first in the Federal Reserve System to appoint a woman director, a Black director, an Asian-American, and a Latin-American to these key positions. And the Los Angeles Board has been the first to include not one, but two very competent

women executives among its current members, Chairman Caroline Ahmanson and Fern Jellison.

Our Directors constantly help us improve the level of central-banking services, and in the most cost-effective manner. Above all, they 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 this District and various sectors of the economy. They 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 statistical data.

Message of the Markets

Heavens knows we can use all the help we can get, especially in view of the great uncertainty which surrounds business and financial prospects in the year ahead. We hope to get more good advice from these wise counselors, but we also plan to listen to the message provided us by the vast impersonal mechanism of the financial markets. Last month we received a very optimistic message. Recovering from its earlier preoccupation with falling prices, falling volume, and falling commissions, Wall Street voiced a loud vote of confidence in official Washington's increasingly determined stand against inflation. In contrast, the long bear market of 1977 and early 1978 sent us a different message, but one with the same underlying moral—the need to curb inflation for the sake of our economy's future health.

Prices of many secondary issues have been rising throughout the past several years, but the broad stock indexes until recently have headed only downward, in this way adjust-

ing for the unhealthy nature of reported corporate earnings. Corporate profits, after adjustment for inflation, are only about 18 percent higher today than they were in 1966, when the Dow Jones industrial average first broke 1,000. Moreover, this does not allow for what inflation has done to the replacement cost of capital investment. In the absence of a good inflation-accounting system, American industry has been grossly overstating its net earnings, and depreciation allowances have fallen steadily behind the escalating cost of replacing facilities. As Treasury Secretary Blumenthal recently argued, this problem underscores the need for some basic tax-reform measures which stimulate greater capital spending by business. The U.S. today has the lowest rate of capital formation of any major country, and this bodes ill for our future economic health. Without more savings and more investment, we cannot create the jobs we need, and cannot sustain the rising standard of living which all Americans consider their birthright.

Prospects for the Economy

Let's now consider the message we're getting from the markets for goods and services. The $2-trillion national economy is still in the midst of the strongest and the longest peacetime expansion of the past quarter-century. The Korean War expansion was somewhat stronger, and the Vietnam War expansion of the 1960's was somewhat longer. But no other expansion of the past generation could match the economy's recent performance—an ability to churn out the yardage, quarter after quarter, ever since the dismal days of early 1975. The expansion has proceeded at a healthy 5.2-percent annual growth over that three-year period, and only two of the quarters in that period have been substandard in growth—including the weather-affected first quarter of 1978.

Many experts have seriously underestimated the strength of this expansion. One reason may be because time was needed to offset the preceding recession—the sharpest and steepest downturn of the past generation. Another reason may be because of the continued high level of reported unemployment. However, we have created almost 10 million new jobs in this three-year-old business expansion—about as many as in the preceding eight years put together. Indeed, we seem to be effectively fully employed. Scarcities of trained workers are developing, the index of help-wanted advertising is at least a third higher than a year ago, and the jobless rate among household heads is down to 3.7 percent.

Admittedly, there is a serious unemployment problem among some groups. Thirty-five percent of black teenagers are listed in the jobless totals, and more than 1½ million workers have been out of work for over six months or have become discouraged enough to drop out of the labor force. But those individuals can find employment only if we develop better training programs, create more low-wage entry-level jobs, or use tax incentives as recently proposed by President Carter—and not if we overheat the economy through shot-gun type programs of economic stimulus. The ultimate irony is that inflationary government policies, leading to subsequent recessions, ultimately raise the average unemployment rate—and strike hardest at disadvantaged groups in society.

At this stage, the big question is whether the expansion can continue, or whether it will drift into recession. On balance we could expect some deceleration in activity, because of the strains beginning to show up in the economy, but we should still be able to avoid recession. Housing and autos, the sparkplugs of

the earlier stages of the recovery, have again strengthened in recent months. Still, they may weaken later, partly because of the heavy load of debt assumed by consumers over the past several years. Meanwhile, we see a speed-up in activity by some of the former slow-growing sectors of the economy. Spending by state and local governments should accelerate, bolstered by Federal grants and by the expanding economy's boost to tax revenues. (We'll know more about Californians' feelings about that subject two weeks from now.) Defense spending may become more expansive, as indicated by the growth of military prime-contract awards, which are running sharply above a year ago.

The prospects for this expansion, and for much else besides, depend heavily on what occurs in business plant-and-equipment spending. At long last, we're beginning to get some optimistic signals from this sector. Indeed, the latest spending surveys suggest a definite turn in sentiment. Moreover, the leading series for business capital investment—capital-goods orders and construction-contract awards—both indicate a significant upturn in this key sector of the economy.

Deficits and Prices

Altogether, there still seems to be considerable life left in the business expansion. However, the relatively optimistic outlook for the economy could be undermined by a worsening of inflationary expectations among consumers and business people. Hence, I want to stress today the vital need to come to grips with the inflation problem. Of course, we shouldn't expect a downturn simply because of the longevity of this business cycle. Business expansions don't die because of old age, but rather because of riotous living in earlier stages of the cycle. But unfortunately,

we *have* indulged in some riotous living—the overstimulus achieved through massive Federal budget deficits, which in turn have created pressures on the Federal Reserve to ensure the financing of those deficits.

Our recent worries, including the decline of the dollar overseas, could be traced in large part to the highly inflationary implications of a widening Federal deficit in the midst of a strong business expansion, from $45 billion in fiscal 1977 to $53 billion in fiscal 1978. And despite the President's decision to ask for a reduction and postponement of the proposed income-tax cut—which was a badly needed move in the right direction—the deficit is likely to exceed $50 billion again in the next fiscal year. At this stage of the business cycle, we should be moving rapidly toward a budget balance or even a surplus, primarily by bringing spending under control. Instead, Congress voted last week to boost spending $45 billion to a total of $499 billion next year—a sharp 10-percent increase.

We all welcome President Carter's threat to exercise his veto authority to keep spending under control. We also appreciate his call for private decision makers to keep wage and price increases significantly below the averages of the past two years. (And Robert Strauss, who is a lawyer, has shown his enthusiasm for the program by pushing for lower lawyers' fees.) But we should recognize the limitations of such incomes policies, which tend to treat symptoms rather than causes. In the present case, organized labor has already rejected the idea of wage restraints, preferring to see first what happens to prices. And in the last analysis, the historical record clearly shows that incomes policies don't work against inflation, in the absence of fiscal and monetary restraints.

Today, many market observers also fear Washington's penchant for creating more inflationary pressures through new legislation. These include the cost and price increases associated with the minimum wage, social-security and unemployment-insurance taxes, the steel "reference price" system, sugar and grain price supports, postal rates, energy policy, the recent coal settlement, and so on. By some calculations, government actions of this sort may add a full percentage point or more to the basic rate of inflation.

The international situation has also contributed to price pressures. Despite a recent improvement, the trade-weighted value of the dollar remains 4½ percent below its level of early last fall. This dollar depreciation helps raise the domestic price structure in several different ways. Higher prices of imported finished goods directly raise the prices paid by consumers. Higher prices of imported materials raise the costs of domestic manufacturers. Moreover, higher prices of foreign goods reduce the pressure to hold down the prices of domestically-produced goods with which they compete in the markets.

The recent acceleration of prices is indeed worrisome, no matter what the source. Food prices, always highly visible, increased at a 16-percent annual rate during the first quarter of the year. Consumer prices exclusive of the volatile food and energy components—that is, items accounting for three-fourths of the entire consumer market basket—rose at an 8-percent rate during the winter months, in contrast to their much lower 5-percent rate of increase during the second half of 1977. Then in April, wholesale prices rose sharply, while the closely watched monthly survey of corporate purchasing agents showed a very sharp increase in the number who reported paying higher prices. Everyone is now paying

more for steel—that basic metal underpinning our entire economy—and everyone is now paying more for other essential materials. On the inflation front at least, Murphy's Law seems to have taken over.

Inflation and Interest Rates

We can't say that we didn't see it all coming. On re-reading the speech which I made here in Town Hall almost a year ago, I realize (with a sinking feeling) that we are now experiencing what I suggested would occur if we failed to get inflation under control. And I might add, it gives me no satisfaction at all to be able to say, "I told you so." We can hope for more progress in the anti-inflation fight in view of the more aggressive stance recently assumed by the Administration and Congress, as well as the Federal Reserve—but success is possible only with a prolonged anti-inflation struggle. Certainly we won't be able to win if the Federal Reserve is forced to carry on the struggle all by itself, because reliance on credit policy to the exclusion of Federal spending policy could threaten the continuation of the expansion through a "credit crunch"—which we want to avoid.

Let's consider where interest rates stand in this inflationary atmosphere. Short-term market rates have risen at least 2 to 2½ percentage points above their 1977 lows, so that commercial paper (for example) is now selling at close to 7 percent. Most long-term rates meanwhile have risen at least one full percentage point above their 1977 lows, so that high-grade utility bonds (for example) now yield almost 9 percent. And judging from some newspaper stories, the Federal Reserve is solely to blame for this surge in borrowing costs.

Most people realize by now that the Federal Reserve is able to put upward pressure on rates in the short-run through a tighter monetary

policy. Many people—but not everybody—also realize that a rising demand for funds in a strong business expansion can put similar pressure on rates. But relatively few people clearly understand the long-term effects of price expectations on interest rates, and the way in which such expectations can offset other market influences. Yet the basic point is quite clear. With prices expected to rise at (say) 6 percent a year, lenders will demand a 6-percent inflation premium plus some basic "real" rate of interest—perhaps 9 percent in all—to protect themselves against an expected long-term loss in the purchasing power of their money. But borrowers will be willing to pay this inflation premium, because they would expect to repay their loans with dollars that are worth 6 percent less each year than the dollars they originally borrowed. So if the Fed happened to ease money considerably in today's circumstances, long-term rates at least would probably go up rather than down, because of an expectation of worsening inflation.

Inflation and Monetary Policy

One point that should be emphasized is that the Fed does *not* take some perverse pride in watching interest rates go up. It acts to tighten money only as a means of preventing excessive growth of money and credit and thereby curbing inflation—the nation's No. 1 problem, according to 82 percent of the people surveyed in a recent Harris poll. The alternative is to watch the distortions of inflation bring about a recession and more joblessness, as we have seen from long experience in this country as well as abroad. With a worsening of unexpected inflation, households become uncertain about the future value of their real incomes, and thus tend to cut back on their spending plans. Similarly, under such conditions, businesses become more

uncertain about the rate of return on new capital, and thus tend to reduce investment in new plant and equipment. The actions of both groups lower the total level of demand in the economy, and thereby tend to raise the unemployment rate.

Now what specifically does the Fed have to do when it receives mixed signals about the future of the 1978–79 economy? Logically, it concentrates on the one "off plan" component of the nation's economic strategy—that is, inflation. As Chairman Miller pointed out in recent Congressional testimony, the Fed intends to maintain money growth at a slower pace this year than last, especially since we overshot our targets on money-supply growth last year. This point emphasizes the Fed's firm commitment to a gradual reduction in money growth to a pace more nearly consistent with reasonable price stability, while still providing adequate money and credit for continued economic growth.

Concluding Remarks

All in all, the economy and the financial markets remain in relatively good shape at this stage of the business expansion—provided that we *reverse* the accelerated inflation that has occured so far in 1978. Despite the increased pressures experienced by depository institutions, credit remains in ample supply except perhaps in the mortgage market. Most borrowers are still experiencing little difficulty in raising needed funds at current interest-rate levels. But at the same time, inflation threatens to undermine the expansion in the different ways I've described. Thus, bringing inflation under control requires a joint effort on the part of all sectors of the economy—government and private alike. As Federal Reserve Chairman Miller recently said, the Fed will be doing its "day-to-day, week-to-week, month-

to-month job of leaning against inflation," but we all know that the Fed can't do the job alone.

Inflation, finally, is the key point at issue in regard to the Federal Reserve's independent stance within the Federal government. The founders of the System knew very well that the power to print money is a difficult temptation for elected officials to resist. They realized that more Executive or Congressional control over the printing press would mean more inflation, whereas central-bank independence would mean less inflation. Now more than ever, in the midst of one of the most inflationary decades of the past century, we need that anchor to windward.