CONFRONTING THE CRISIS

Remarks of

John J. Balles

President
Federal Reserve Bank
of San Francisco

Meeting with Hawaii
Community Leaders

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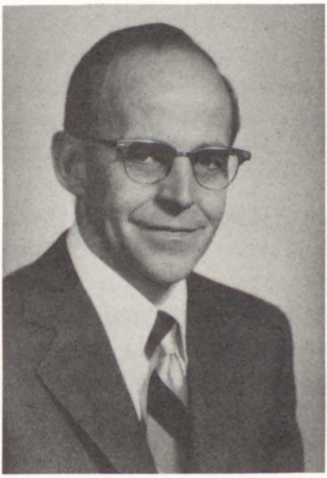

The nation must take strong measures to overcome the new outburst of inflation which has undermined the economy so badly in recent months, Mr. Balles says. In an unprecedented step, the Administration has re-opened the books on its 1981 budget only a month and a half after sending it to Congress, as a means of ending the inflation stimulus created by continued massive Federal deficits. But much more remains to be done along that line, with increased emphasis on spending cutbacks rather than tax boosts. Also, to cure inflation, the Federal Reserve must slowly yet steadily reduce the rate of growth of the money supply, continuing along the path it has followed over the past six months.

On this visit to these beautiful islands, I'm reminded of a famous episode in Hawaiian history which might suggest the state of the national economy today. Just picture yourself at Pali Pass, with the rampaging army of Kamehameha in front of you and a steep precipice at your back. Now substitute the words "inflation" and "recession," and you'll get the picture.

Our economy indeed is in serious trouble—perhaps the worst crisis since World War II—and those problems affect Hawaii as they do the Mainland. Still, if history is any guide, we should be able to overcome our problems with the proper exercise of monetary and fiscal policy. I'd like to review with you today the steps that are being taken to confront the crisis. But first, let's summarize briefly the developments of the past decade that have brought us to our present difficult situation.

Cause of Today's Problems

Actually, the 1970's were not all bad. On the positive side, the national economy grew 33 percent (in real terms) between 1969 and 1979—a substantial gain, even though it failed to match the 50-percent gain of the preceding decade. The economy created jobs for 19 million people during the 1970's, and that 24-percent gain was considerably larger than the previous decade's increase. Again, real disposable per capita income—a key measure of individual well-being—increased 28 percent in the 1970's, or almost as much as it did in the 1960's. But the nation ate up much of its seed corn in reaching its higher standard of living. Real business investment increased only one-third as fast, and worker productivity less than half as fast, as in the preceding decade. Worse still, the nation became increasingly dependent for its raw materials on unstable and expensive sources of supply, as evidenced by a 15-fold rise in the price of Middle Eastern oil over the decade.

Moreover, we're suffering today from the fact that economic growth in the 1970's depended so heavily on public-sector spending. In particular, massive Federal-spending increases outpaced tax revenues and created red ink on the books for every single year of the decade. Indeed, the combined Federal deficit for the decade, $315 billion, matched the combined total for the entire previous history of the Republic. And inflation became an ever-worsening problem in the 1970's, reflecting this prolonged series of deficits, the overly stimulative monetary expansion that sometimes accommodated them, and a series of supply-related shocks from the OPEC nations and elsewhere. Consumer prices practically doubled over the course of the decade, in the worst peacetime inflation in the nation's history.

Recession Problem

We're paying the price in 1980 of failing to deal more forthrightly with the problems which originated in the 1970's. Recession, or a situation closely resembling recession, is an obvious consequence of the past decade's excesses, and of the stringent policy moves needed to cure those excesses. Now it's true that the long-awaited recession isn't here yet; according to preliminary figures, the national economy grew almost as fast in the first quarter of 1980 as it did in the final months of 1979, at about a 1-percent annual rate. Still, the index of leading cyclical indicators has declined for five months in a row—and this is often an important sign of impending recession or at least a definite slowdown in business activity. Moreover, with inflation soaring, the real buying power of consumers has declined over the past year, just as it did in the 1974-75 inflationary recession.

Some areas of the economy still look rather strong, especially those dependent on defense spending or energy-development programs. On the other hand, industries producing postponable consumer items have been weakening since last fall, or even longer. Residential construction has been in the doldrums for more than a year, reflecting soaring costs and expensive (or even non-existent) mortgage credit. New-auto production has lagged for some months, and Detroit's spring production schedules are at the lowest seasonal level of the past 15 years. Those industries' major suppliers—such as steel, lumber, rubber, and so on—consequently are also suffering. And you don't have to be reminded that tourism has also weakened because of consumers' reduced take-home pay, as well as soaring fuel prices and airline fares.

Inflation and Energy

Recession is indeed a possibility, and may soon be an actuality. But it's worth repeating that recession is not the basic problem, but rather a consequence of our earlier actions. The basic problem is inflation, and this has been true throughout the past decade and more. Inflation undermined the otherwise commendable record of income and employment growth achieved during the 1970's, when consumer prices doubled within a single decade. Yet if the recent trend continues, we might see prices double again within only a half-decade. Worse still, the expectations in government and in the marketplace suggest that progress against inflation will be only halting, at best, in the years ahead. The Administration, for example, believes that the 3-percent inflation goal laid out in the Humphrey-Hawkins Act will not be reached until 1988.

Let's consider some of the factors that have been blamed for our severe inflation problem, beginning with energy. The numbing series of oil price increases of the past decade culminated in the doubling (or more) of OPEC prices in 1979 alone. In dollar terms, the U.S. paid less than $5 billion a year to the oil exporters prior to the 1973 embargo, but it now is paying them almost $57 billion a year for imported crude supplies. The latest price upsurge has meant a 47-percent rise in energy costs for U.S. consumers since a year ago, as well as steep increases for producers which will filter through the economy for some time to come. And despite some signs of a short-term oil glut, the long-term price outlook is not too good, especially as more nations follow the Iranian example, gaining increased revenue while sharply reducing supply.

On the more favorable side, the U.S. has provided good evidence that it can adjust to a world of higher energy prices. Even with limited price decontrol, per capita energy usage increased only 5 percent between 1972 and 1978, compared to a 21-percent increase in the preceding six-year period. (In volume, that difference amounted to about 6 million barrels a day.) And by decontrolling domestic crude-oil prices—a process to be completed over the next 18 months—the government is sending American consumers an unambiguous signal to conserve even more.

Inflation and Interest Rates
In another area, many observers point to the stratospheric level of interest rates as a major cause of inflation, reasoning that business firms will have to boost prices when they're

forced to pay 20 percent or more for credit. But they ignore the fact that high interest rates are a symptom rather than a cause of inflation —not to mention the fact that they serve a useful purpose in forcing reduced reliance on credit. Now, most people understand the role of business fluctuations in pushing rates up and down. In recent decades, interest-rate peaks have roughly coincided with business-cycle peaks, and interest-rate lows have usually followed recession lows after a few months' time. Most people also understand (at least dimly) the short-term ability of the Federal Reserve to push rates down through easier money conditions or to push rates up through tighter policy.

Yet too few people understand the long-term effects of price expectations on interest rates, and the way in which such expectations can offset other market influences. Today, for example, when people expect prices to rise at (say) 10 or 15 percent a year, lenders are demanding the "real" underlying rate of interest plus 10 or 15 percent, so that they'll be protected against an expected loss in the purchasing power of their money. Borrowers meanwhile are willing to pay this inflation premium, because they expect to repay their loans with dollars that are worth 10 or 15 percent less each year than the dollars they originally borrowed. The point is that we should put the horse before the cart and work to curb inflation if we want to keep interest rates in check.

Inflation and Deficits

Where then should we look to find the basic source of our inflation problem? I would suggest the Federal budget, which has aggravated the inflation problem during the recent cyclical expansion by generating a massive series of deficits, which then induced a substantial over-expansion of the money supply. Part of the problem was the monetization of debt which resulted from the Federal Reserve's former operating techniques, which sometimes involved a slow adjustment to inflationary pressures because of the Fed's attempt to limit the impact of rising interest rates on private sectors of the economy. This link was broken last October 6, when the Fed shifted from an interest-rate operating technique to direct control of growth in bank reserves, and hence in the money supply. The aim since that time has been to slow the growth of the money supply to a point where it will be consistent with price stability.

But we're still experiencing the results of that earlier problem. Moreover, much of the run-up in inflation expectations early this year could be traced to the belief that our budgetmakers had lost control of that engine of inflation. The fears about a runaway budget surfaced before the ink was dry on the January document, when it became apparent that Federal spending in the current fiscal year would not be as "lean and austere" as projected a year ago, with the result being a $40-billion deficit in fiscal 1980. Again, the January document indicated that the fiscal 1981 deficit would be reduced to about $16 billion—but many observers concluded that the deficit would be considerably higher because of under-estimation of expected outlays and over-estimation of expected revenues.

Indeed, the original budget appeared certain to remain considerably out of balance, even in the face of about $50 billion in tax increases—either from the social-security tax, the windfall-profits tax, or inflation-related boosts in personal-tax revenues. With that, the tax burden would be proportionately greater than at practically any other time since the height of World War II. And one more statistic: projected outlays for 1984 jumped almost one-fourth, to $839 billion, just within the one-year interval between the publication of the last two annual budget documents. Thus, the initial market reaction to all these gloomy statistics was a heightening of inflationary expectations—a key factor in sharply rising long-term interest rates.

Inflation and Crowding-out

Now, substantial budget deficits can be defended in deep recession periods, because they support aggregate business activity at times when other credit demands are weak. But that condition hasn't existed in any of the last several years of essentially full employment. Instead, heavy deficit financing has led to intense pressure on credit markets and to greater inflation, by inducing an excessive monetary expansion—understandably, because the Federal Reserve tended to lag in restricting credit availability to the private sector. As a result, interest rates have come under sustained upward pressure, and higher interest rates have "crowded out" many private borrowers from the money and capital markets, because they could not pay what the Treasury could pay for funds. Over time, this has helped cause a greater portion of aggregate savings to go to the public sector, and thus has led to less productive investment and to a decline in the nation's real-growth potential.

The "crowding out" argument was widely discussed—and also frequently ignored—in the mid-1970's. But now we're face-to-face with the truth of that thesis. At a time when Federal Reserve monetary policy is obviously tightening, and when private credit demands are still strong, the Federal government's borrowing demands have been rising rather than declining, with severe consequences for the markets.

Much of the Federal borrowing pressure comes from Federal entities which are classified "off budget," but which are still financed by the U.S. Treasury, such as the group of credit agencies operating under the wing of the Federal Financing Bank. Other pressures come from privately-owned but government-sponsored enterprises, primarily those operating in the mortgage market. In any event, total Federal and federally-assisted credit demands could reach $95 billion or even more in calendar 1980, at a time of strong credit demands elsewhere. (At that level, the Federal government could pre-empt almost one-fourth of all credit demands, compared to less than a one-sixth share during the first half of the 1970's.) Thus, none of us should be surprised at the stratospheric level of interest rates which results when money growth is obviously slowing, and when the Federal government is taking a larger share of available funds.

These considerations indicate why the drive for a truly balanced budget is at the heart of our anti-inflation struggle. It may be difficult to reach that goal in light of the need for real increases in defense spending, but that simply means that stiff cutbacks elsewhere are essential if we are ever to reduce the government sector's excessive demands on the nation's resources. The Administration has made a good start by reopening the books on the 1981 budget, and proposing a $16½-billion surplus rather than a $16-billion deficit. Yet most of that shift represents a sharp increase in revenues rather than spending cutbacks. Revenues are now expected to be

$28 billion higher than first proposed, because of the gasoline-import fee, the withholding of interest and dividend income, and a further inflation boost to income-tax revenues. Moreover, the proposals to balance the 1981 budget must still be adopted by the Congress. Finally, and most importantly—as many observers have noted—little has been done to date to cut Federal spending and a $37-billion deficit in the **current** fiscal year. The problem of rampant inflation and skyrocketing interest rates is here and now.

I would argue that the government could make a greater contribution to the anti-inflation fight by restricting spending rather than by boosting revenues. Our elected representatives in Congress should take the lead here. First, they must overhaul the legislative process itself—especially considering that, in 1979, Congress passed three times as many bills that contributed to inflation as did the reverse, according to a recent study by the National Association of Business Economists. Again, Congress would do well to follow-up on the Congressional Budget Office's list of 58 areas of possible budget cutbacks—including, for example, the modification of indexing requirements for social-security benefits and other Federal programs, which could yield $70 billion in savings over a five-year period. (Almost $40 billion of that total could be saved by granting social-security recipients an 85-percent adjustment instead of a 100-percent adjustment for increases in the consumer price index, which is logical because of the CPI's tendency to overstate the actual inflation rate.) Such cutbacks are politically difficult to enforce, of course, but they are also essential to our long-term economic health.

Inflation and Monetary Policy

Monetary policy meanwhile has a crucial role to play in restoring price stability, especially in view of the fact that excess money creation helped create the problem, in the wake of the excess credit demands generated by Federal deficit financing and other forces. Over the 1975-79 business expansion, the M-1B measure of the money supply grew at more than a 7-percent annual rate—faster than in the 1970-74 period, and almost twice as fast as in the less inflationary period of the 1960's. The M-1B measure, incidentally, consists primarily of currency plus demand and other check-type deposits.

The Federal Reserve, recognizing that price stability requires a progressive reduction in money-supply growth, moved aggressively last October 6 to enforce its tight-money policy decisions. In particular, it placed more emphasis on controlling bank-reserve growth, and placed less emphasis on minimizing short-term fluctuations in interest rates. The early returns are quite heartening. In the six-month period prior to October 6, the M-1B money supply increased at more than a 10-percent rate; in the subsequent six months, the estimated growth rate averaged roughly 6 percent—which means that at present we are within the 4-to-6½ percent range set by the Fed for 1980. Moreover, according to Chairman Volcker's recent testimony to Congress, the Fed's desired target growth rate for this measure in 1980 is the midpoint of the 4-to-6½ percent range, implying further deceleration of monetary growth.

The most heartening recent development in this area was the passage two weeks ago of legislation which should strengthen the Federal Reserve's hand in the anti-inflation struggle, and also strengthen the foundations of the nation's financial system. The legislation goes by the tongue-twisting title of "The

Depository Institutions Deregulation and Monetary Control Act of 1980," and despite being almost overlooked in the media, it ranks as probably the most important piece of financial legislation of the past generation. It helps to solve the problem of declining Federal Reserve membership, by reducing the cost of reserve requirements for member banks. It helps to support equity and to improve monetary control, by extending reserve requirements to all depository institutions with transactions accounts (check-type accounts) and non-personal time deposits. And it helps to promote greater competition in financial markets, primarily by phasing out deposit interest-rate ceilings and by broadening the asset and payments powers of banks and thrift institutions. The new legislation makes a number of basic structural changes, and in the process, it increases the effectiveness of monetary policy in confronting the inflation problem.

The measures taken on March 14 represent yet another segment of the overall anti-inflation program, with the Federal Reserve broadening its policy of restraint, as a means of spreading the impact of its policies more evenly throughout the credit markets. The consumer-credit restraint program for many lenders and retailers, and the voluntary credit-restraint program for banks, could be helpful in diminishing credit demands, and thus in helping to moderate upward pressures on interest rates. Yet despite this increased attention to lending policy, the Fed will continue to base its credit-restraint program mainly on its control of money-supply growth.

Implications for Hawaii
Before concluding, I'd like to review briefly how Hawaii may be affected by the nation's

present difficulties. Let's start with tourism—a crucial sector, since visitors make up one-tenth of all the people here on the islands at any one time. Many of the factors which cut into the tourist traffic last year (at least, from the North American market) have worsened since then. Inflation continues to reduce real household income, and fuel prices (hence, airline prices) continue to soar, thereby grounding many families and conventioneers who would like to spend their holidays in this island paradise. And tourists from Pacific countries, who were so plentiful last year, may be less in evidence in 1980, in view of the slower economic pace in Asia and a sharp decline in the value of the Japanese yen. Construction prospects also appear weak, because of the same factors that are reducing construction activity nationwide. But despite that slowdown, I suspect that housing prices here will continue to amaze even us hardened Californians.

On the other hand, increased spending for defense and other government purposes should continue to provide strong support for the state's economy. This sector, as you know, already accounts for one-fourth of total employment in Hawaii. Another promising factor is the increased diversification of the state's economy, which has helped to sustain business activity here even in the face of several Mainland recessions. And once past our present difficulties, the future looks promising indeed for this island community, situated as it is at the crossroads of the most dynamic segment of the world economy.

Concluding Remarks

To sum up, my remarks today suggest that we must take strong measures to overcome the new outburst of inflation which has undermined the economy so badly in recent months. The Administration has taken an unprecedented step by re-opening the books on its 1981 budget document only a month and a half after sending it to Congress, with the intention of ending the inflation stimulus created by continued massive Federal deficits. But as I've suggested, much more remains to be done along that line, with increased emphasis on spending cutbacks rather than tax boosts. The Federal Reserve meanwhile has broadened its policy of restraint, as a means of spreading the impact of its anti-inflation policy more evenly throughout the credit markets. Only a coordinated program of fiscal and monetary restraint can reduce the danger of "crowding out" and restore stability to our credit markets.

With conditions as bad as they are, is there anything more we should do? Well, we could try the one unworkable solution that has been implemented in every crisis from the days of Hammurabi and Diocletian to the days of Richard Nixon—a wage-price freeze. But in my personal view, mandatory controls are unnecessary if more basic reforms are adopted, while they actually aggravate the situation if they become substitutes (as they usually do) for such basic solutions. To overcome inflation, we must follow the demanding, but necessary, course of action which I've already outlined—institute stiff cutbacks in Federal spending, while slowly but steadily reducing the rate of growth of the money supply. Unfortunately, we cannot expect quick results. History shows that there is an unavoidable lag between the imposition of a program of monetary restraint and the eventual return of price stability. But it is imperative that we continue to follow this basic cure for inflation, with the steady application of disciplined monetary and fiscal policies.