PROBLEMS: ENERGY, RECESSION, AND INFLATION

Remarks of

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Inflation remains our most important problem, says Mr. Balles, and it cannot be overcome without a sustained policy of monetary and fiscal discipline. The Federal Reserve is determined to seek reduced rates of monetary expansion over coming years, to help bring about a return to price stability. But the Fed cannot accomplish its task without a parallel reduction in Federal-government spending and borrowing pressures.

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I'm glad to be back again in the Great Outdoors, where we can listen to the gurgle of the oil through the pipeline, and watch the greenbacks flutter to earth against the backdrop of the Midnight Sun. What that travelogue language suggests is that the economic outlook looks much better from Alaska than it does from the Lower 49. Alaska of course has many difficulties to face, but in terms of the nation's economic situation, it's part of the solution, and not part of the problem.

Most of the nation's problems have worsened since my last visit to Alaska two years ago. Total production in the national economy dropped at a 9-percent annual rate last quarter, in contrast to an **increase** of like magnitude in the spring quarter two years ago. About 7.8 percent of our labor force is now unemployed—about two percentage points higher than the jobless rate two years ago. And to cap off this recitation of problems, the general level of prices is 19 percent higher now than it was in mid-1978—in particular, with consumers paying 67 percent more for energy than they did then.

Problem of Energy

Let's consider in turn each of the nation's major problems, beginning with energy. The numbing series of oil price increases of the past decade culminated in the doubling 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 roughly $80 billion a year for imported petroleum. And despite some signs of a short-term oil glut, the long-term outlook is not good, especially as more nations follow the Iranian example, gaining increased revenue while sharply reducing supply.

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The United States, like the rest of the world, faces a massive challenge of moving from a mostly oil-based energy economy to one based on other energy resources before the year 2000. The Exxon Corporation study, **World Energy Outlook**, argues that we can obtain a high rate of energy production from non-oil sources over the next 20 years; for example, with coal production more than doubling, and nuclear power expanding more than five-fold over that period. The study also assumes that the world economy will improve the efficiency of energy use, with energy consumption growing only 2.5 percent a year over the next two decades, while real gross national product rises at 3.5 percent annually. But the Exxon analysts conclude that world demand for oil in the year 2000 will still reach 60 million barrels a day—about 15 percent more than the current level of demand. At that point, reserve-to-production ratios would fall to very low levels, which in turn would aggravate the price surge and intensify the worldwide struggle for new energy sources.

The nation's energy problem thus is likely to worsen—but as I suggested already, Alaska should be part of the solution. As you know, it's difficult to say just how much petroleum wealth Alaska possesses—not to mention natural gas and other resources. Estimates from the U.S. Geological Survey, which are rather conservative by Alaska standards, suggest that the state's recoverable reserves of petroleum are in the range of 22 to 59 billion barrels—putting Alaska in the same league as Venezuela or the Soviet Union. But no one really knows, for only 136 wells have been drilled in this state since 1900, compared with more than 2 million wells in the rest of the country. Moreover, I understand that only seven oil rigs are now at work here, compared with more than 800 in

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Texas. Perhaps those numbers should be reversed. The state, of course, as owner of the land underlying the vast Prudhoe Bay field, will obtain a one-eighth royalty from its increasingly valuable oil and gas holdings. Alaska thus will profit while helping to overcome a serious national problem.

Problem of Recession

Let's next consider the serious problem of recession now affecting the national economy. Most experts had been expecting a cyclical downturn in the economy for some time, but when the shoe finally dropped, the sound was much worse than expected. As I noted at the outset, real GNP dropped at a 9-percent annual rate during the second quarter of this year—a much sharper drop than we usually experience in the opening stages of a recession. The slump in activity was most pronounced in the housing and auto sectors, but the decline was not limited to those sectors. Retail sales (excluding autos) dropped considerably from their early 1980 peak, and business outlays for plant and equipment also declined.

The indicators today are rather mixed, with the slump continuing, but with some positive signs also beginning to emerge. Retail sales turned around in June after four months of sharp decline. Home building activity increased sharply in the same month, although still lagging 37 percent behind the year-ago figure. Sales of domestically produced autos edged up slightly in July, although the totals still were the worst for any July of the last 18 years.

Obviously, we can expect to see some dismal statistics this summer and fall. Inventories, for example, appear to be too high in relation to recent levels of sales, although most business

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firms have been much more cautious in their inventory buildup than they were in the last business expansion of the early 1970's. Some domestic industries appear to have severe long-term problems—Detroit, for example, with imports now accounting for almost 30 percent of the U.S. auto market. And the jobless rate, after stabilizing at around 7.8 percent for the past several months, from past evidence will probably rise further in coming months. On the other hand, the atmosphere in financial markets has brightened considerably since the near-chaotic conditions of early 1980. Interest rates dropped by half or more in the late spring months—although some of that drop has been offset lately—while an old-fashioned bull market seems to have taken hold on Wall Street.

Problem of Inflation

This rebirth of optimism undoubtedly reflects the popular belief that we are at last making some headway against inflation, the most crucial of the problems now facing the nation. However, we should beware of the signals given off by some measures, such as the consumer-price index. That index may overstate the easing of the price trend, just as it overstated the early-year upsurge in prices, largely because it gives too much emphasis to the purchase and financing costs of new housing. More importantly, we must not permit the slowing of inflation to lead to complacency about this problem, and above all, we must not respond to the recent rise in unemployment by adopting stimulative fiscal and monetary policies when the recession is nearly over. If that happens, we can be sure that prices will be rising more rapidly at the start of the next recovery than in any preceding recovery, and that we will lose our chance of ending inflation in the foreseeable future. The nation simply

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cannot afford to repeat the experience of the 1970's, when stimulative policies led to a doubling of prices within a single decade.

The national economy has been subject to external price "shocks" several times within the past decade, and we may encounter more of the same in future years. As I've already said, the pressures in the world oil market all but guarantee a rising trend of energy prices in the years ahead. In addition, food prices are likely to rise sharply in the short term, as a result of the severe weather problems now affecting food production worldwide. Business cost pressures may moderate as the economy begins to recover, but the recent record doesn't create much confidence on that score. In the first half of this year, unit labor costs soared at a record 14-percent annual rate, reflecting sharp gains in labor compensation and severe declines in the productivity of the workforce.

Monetary Policy and Inflation

Monetary policy will have a crucial role to play in the anti-inflation fight, considering that excess money creation helped to bring about 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 fall to enforce its anti-inflation policy decisions. To that end, the Fed began to place more

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emphasis on controlling money-supply growth, and less emphasis on minimizing short-term fluctuations in interest rates. That policy has been successful. In the six-month period prior to the October 6 policy shift, the M-1B money supply increased at more than a 10-percent annual rate. Since that time, the money supply has increased at about a 4-percent rate.

Because of this policy of monetary discipline, last winter's severe inflation expectations began to evaporate. Interest rates responded, until recently, by dropping sharply from their stratospheric highs. The recent turnaround in rates suggests, however, that inflation fears are still alive—and those fears have gained support from the sharp rise in producer prices just announced for July. Still, as time goes on, we should see results of our monetary policy in a lowering of the underlying inflation rate, in view of the lag of two years or more that is usually involved between the reduction of money growth and a reduction of the inflation rate. But a period of sustained price stability cannot be assured until we rein in those forces which have led to the past record of excessive money creation—primarily such factors as excessive Federal-deficit spending.

Inflation and Fiscal Policy

No one can deny the close connection between the doubling of prices and the upsurge of deficit financing over the past decade. The combined Federal deficits of the past decade reached $315 billion—about the same as the total deficits recorded in the nation's entire earlier history. Most recently, the Federal government has continued to run huge deficits even in the late stages of one of the longest business expansions of the past generation. In the fiscal year ending next month, under the impact of recession, we will post a near-record $61-billion

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deficit. Moreover, in fiscal 1981, despite all the earlier talk of a surplus, we may expect a $30-billion deficit—even if no tax cut is enacted.

Needless to say, we are now hearing discussions of a tax cut on every hand. Such discussions are not hard to understand, since cutting taxes puts more money into people's pockets, which would encourage them to increase their spending and thus help end the recession. Also, without a tax cut, the tax burden on most people would rise significantly next year, by more than $50 billion if present laws remain unchanged. A combination of inflation and a "progressive" income-tax structure could generate an extra $20 billion in tax revenues. Another $17 billion is expected from higher social-security taxes, because of the need to pay benefits that rise constantly as a result of being indexed to inflation. And yet another $15 billion or so is likely to result from the "windfall" profits tax on oil companies.

A good case can be made for tax reductions, first to reduce the tax burden on the nation's people, and secondly to stimulate job-creating and productivity-enhancing business investment. However, I would give equal importance to sharp spending cutbacks, which are essential if we hope to reduce the government sector's excessive demands on the nation's resources. The task won't be easy, especially in view of the broad support for the Administration's plan to increase defense spending by 25 percent (in real terms) over the next half-decade. But prudent reductions across a wide range of nondefense programs are both possible and necessary. In this connection, the Congressional Budget Office has provided a list of 58 areas of possible budget cutbacks—including, for example, changes in indexing requirements for social-security benefits and other programs,

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which could yield $70 billion in savings over a five year period.

While reducing Federal spending pressures, we should also try to reduce Federal borrowing pressures in financial markets, with special attention to those activities which are not financed through the budget. Some borrowing pressures arise 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. Altogether, total Federal and Federally-assisted credit demands could reach perhaps $112 billion this year—about one-fourth of all credit demands. In a recession period, this may not be overly burdensome. But in a recovery period, as productive resources become pressed by strong private demands for goods and services, the Federal government could preempt the loanable funds needed for financing private capital formation, and in the process hamper the needed improvement in the nation's productivity.

Concluding Remarks

To sum up, the nation today confronts some very serious problems, which will take much time and much discipline to overcome. The energy problem will be with us for decades, but it can be overcome through increased attention to energy conservation, and through an increased search for new resources, such as those here in Alaska. The recession problem can and probably will be overcome in a reasonably short period of time, through the economy's normal recuperative powers and the "automatic stabilizers" operating through the

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Federal budget. But recession will continue to be a threat until we get our serious inflation problem under control. By causing economic imbalances, inflation has helped impose serious recession and unemployment upon our country twice within less than a decade.

Inflation remains our most important problem, and we cannot surmount it without a sustained policy of monetary and fiscal discipline. The Federal Reserve is determined to seek reduced rates of monetary expansion over coming years, to help bring about a return to price stability. But the Fed can't accomplish its task without a parallel reduction in Federal spending and Federal borrowing pressures. The cutbacks I've suggested are politically difficult to implement, of course, but they are also essential to our long-term economic health.

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