AGENDA FOR THE NATION

Remarks of

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

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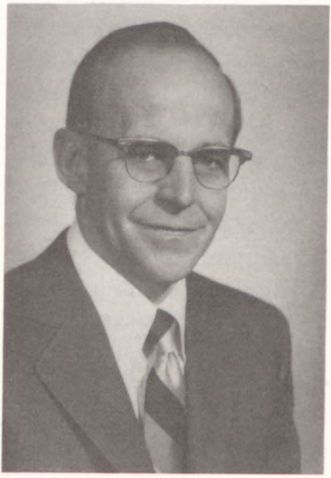

Inflation is usually defined as "too many dollars chasing too few goods," says Mr. Balles, so two major approaches should be followed in the search for a solution. "A solution should involve the development of long-term measures to increase the supply of goods, which means overcoming the energy crisis, improving productivity, and taking other measures to unleash the productive powers of the U.S. economy. But the solution also should involve limiting the supply of dollars, which means following a conservative monetary- and fiscal-policy course."

I'm glad to be back in Phoenix again, to renew acquaintances with the leaders of one of the most dynamic communities in the dynamic Sun Belt. Arizona like the nation has many problems, but the state's record supports an argument that I've always made—the problems of **growth** are much less serious than the problems of **no growth.** I'd like to spend my alloted time today discussing some of the problems—problems of both types—that the new Administration will have to face when it takes office. But first let me pause to discuss another purpose of this meeting, which is to give Phoenix's community leaders a chance to get together with the directors of our Los Angeles office. Our directors are an able and diverse group of individuals, and they help in many important ways to improve the performance of the Federal Reserve System, the nation's central bank.

Role of Directors

The directors at our five offices are involved with each of the major tasks delegated by Congress to the Federal Reserve. That encompasses the 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 in particular, the development of monetary policy. We are fortunate in the advice we get from them in each of these areas.

Our directors constantly help us improve the level of central-banking services, in the most cost-effective manner. This is a crucial role at the present time, because under the terms of the new Monetary Control Act, the Federal Reserve is moving into a new operating environment. Over the next year, the Fed's services will be made available to all depository institutions offering transaction (check-type) accounts and nonpersonal time deposits, and those services will be priced explicitly for the first time.

Yet above all, our directors 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 our district and various sectors of the economy. Our directors thus 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.

Outlook for the Nation

We need their insights today more than ever, because of the vast uncertainty which surrounds the outlook for the year ahead. There is nothing uncertain, however, about the mandate which the new Administration and the new Congress bring to Washington. The people have spoken, and spoken loudly, of their desire for an improvement in the nation's economic performance. Specifically, they have set forth an agenda centered around the necessity to bring inflation finally under control.

Before we consider how to accomplish that task of mastering inflation, let's consider what lies ahead for the real economy in the period immediately ahead. The basic question is, "Will 1981 be a year of recovery or of renewed recession?" The nation suffered from a severe downturn in the late winter and spring months, but business activity then began to recover in the third quarter. For four straight months we've witnessed increases in the set of leading indicators which usually foretell changes in the business climate. Moreover, industrial production and nonfarm employment have risen significantly throughout the past three months, and the jobless rate has stabilized after a surge during the recession period.

A look at the statistical record suggests a useful rule-of-thumb for measuring the strength of the recovery. In the typical business cycle, real GNP rises at about a six-percent annual average rate over the first six quarters of recovery. Well, this isn't a typical business cycle, and so you shouldn't expect to see that type of surge in business activity in the year ahead. The latest statistics suggest that real GNP will decline by just one or two percentage points between the fourth quarter of 1979 and the fourth quarter of 1980, and most forecasters expect an increase of similar modest size over the course of 1981.

We're not out of the woods yet, as shown by the fact that industrial production lags more than four percent below the year-ago level. And the recovery may continue uneven, with some quarters next year back in minus territory. The basic reason for the expected weakness of the recovery is inflation. Inflation pushes up interest rates, and thus undermines the strength of housing and other interest-sensitive industries; and inflation restricts the options of policymakers, who might otherwise adopt stimulative policies to get the economy off dead center.

Still, there are many elements of strength in the economy, as evidenced by the boom conditions in the energy and defense industries. The consumer sector, which accounts for two thirds of total spending, is now in better financial shape than it was during the late 1970's, and that sector's recovery has bolstered total spending. In addition, the summer and early-fall improvement in overall demand has reduced the likelihood of a major inventory liquidation, and thus of a serious slide in total output. But the overall prospect is for an uneven and sluggish recovery.

Outlook for Arizona

"Sluggish recovery" appears to be a useful description of current conditions in the regional as well as the national economy. Throughout the past decade, we could usually assume that Arizona would prosper despite whatever happened to the national economy. We've seen this year, however, that Arizona's prosperity can be undermined by major national developments. Copper demand has suffered because of the deep recession affecting the durable-goods manufacturing industries of the Northeastern states. (Indeed, prices for the red metal would have weakened considerably had it not been for the prolonged strike in the industry.) The state's tourist industry also has suffered to some extent because of the depleted incomes and high fuel prices affecting out-of-state visitors.

Still, the factors that provided the foundation for the boom of the 1970's—led by the continued in-migration of new people and new industries—should keep the state on an upward growth path. Also, in typical Sunbelt fashion, Arizona doesn't have to worry about declining manufacturing industries, such as autos and steel, which are concentrated in Snowbelt States. Rather, Arizona can benefit from a manufacturing sector concentrated in industries, such as aircraft and electronics, which have strong growth prospects.

Arizona's Sunbelt-type industrial structure, and the state's Sunbelt-type business environment, thus should support significant growth throughout the decade ahead. In 1981 as in 1980, the state may grow at a slower pace than you've become accustomed to, because of the continuing impact of a sluggish national economy. But in 1981 and in the decade as a whole, Arizona's $24-billion economy should continue to outpace the national economy. As you well know, Arizona outdistanced all other states in terms of population growth during the 1970's, with a 52-percent increase that was five times larger than the national percentage gain. The foundations are in place for another increase of a million or more people in the 1980's, with all that that means for job prospects in manufacturing, construction, trade, services and other industries.

Inflation—Basic Agenda Item

The regional and national recovery could yet be undermined by inflation—and here we return to the basic item on our agenda for the future. The problem is obvious. Inflation, as measured by the consumer price index, doubled within the single decade of the 1970's, and would have doubled again within only a half-decade if the pace of early 1980 had been maintained. Luckily, the pace has since decelerated; between March and September, consumer prices increased at a 9-percent annual rate, compared with the 16-percent pace of the preceding six-month period. Much remains to be done, however, to reduce the inflation rate to more acceptable levels.

The problem reflects not just external price "shocks"—of which we've had more than our share—but also the uptrend in the underlying rate of inflation. American households are now suffering from their second major oil-price shock, as evidenced by the two-thirds increase in the energy component of the consumer price index over the past two years. Moreover, despite the current glut, most energy analysts expect a rising trend of prices over the longer-term, with the gradual depletion of the world's low-cost oil reserves. Food prices meanwhile seem likely to rise sharply in the near-term future, as a result of the severe weather problems affecting food production worldwide. By some estimates, food prices could rise at a 15-percent annual rate over the next year—almost double the gain of the past year.

Still, food and energy account for only about one-fourth of our household budget, and inflation has been rampant in the other three-fourths of our budget as well. Throughout much of the past decade, the underlying or core rate of inflation remained high, but still below six percent a year. Over the past year, however, the underlying rate has exceeded nine percent. That price spiral reflected two factors. One was an upsurge in unit labor costs, because of sharp gains in labor compensation and severe declines in the productivity of the nation's workforce—although productivity improved last quarter with the business upturn. The price rise of course reflected also the excessive money growth of past years, when monetary policy was pushed off course by the excessive credit demands created by Federal deficit financing and other forces.

Inflation has frequently been defined, quite simply, as "too many dollars chasing too few goods." A solution thus should involve the development of long-term measures to increase the supply of goods, which means overcoming the energy crisis, improving productivity, and taking other measures to unleash the productive powers of the U.S. economy. But the solution also should involve limiting the supply of dollars, which means following a conservative monetary and fiscal-policy course.

Limiting the Supply of Dollars

Monetary policy will have a crucial role to play in carrying out the national agenda, especially in view of the part played by excess money creation in the development of the inflation problem. The Federal Reserve, recognizing that price stability requires a progressive reduction in money-supply growth, moved aggressively a year ago to enforce a stronger anti-inflation policy. To that end, the Fed began to place more emphasis on controlling money-supply growth and less emphasis on minimizing short-term fluctuations in interest rates, since the latter indirect approach had failed in the past to limit money growth. The policy has been broadly successful,despite unfortunately large fluctuations around the growth trend. In the six-month period prior to the policy shift, the M-1B measure of the money supply increased at more than a 10-percent annual rate; over the following year, however, the money supply increased about 7-percent—a substantial improvement, although above the top of the Fed's target range for the year. The M-1B measure, incidentally, consists primarily of currency plus demand and other check-type deposits.

The historical record suggests that any prolonged reduction of money growth will be followed, with a lag of two years or so, by a reduction in the underlying inflation rate. The past year's deceleration in money growth thus should have favorable results for prices, especially if the Fed is successful with its announced policy of bringing about further deceleration in coming years—for example, with a half-percentage-point reduction in the target range for 1981. But a period of sustained price stability cannot be assured until we control those forces which have led to the past record of excessive money creation—primarily such factors as excessive Federal-deficit spending.

Limiting Federal Deficit Financing

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 1970's reached $315 billion—about the same as the total of all deficits recorded in the nation's entire earlier history. Moreover, the Federal government ran huge deficits, instead of surpluses as it should, throughout the 1975-79 period—one of the longest business expansions of the past generation. Then, in fiscal 1980, the deficit reached a near-record $59-billion figure. And in the new fiscal year, despite all the earlier talk of a surplus, the deficit could be almost as large, according to many private analysts. The new Administration will make its presence felt here, of course, but the fiscal year may be fairly far advanced before Congress acts on these new plans.

In fiscal 1981, Federal revenues could jump about 15 percent above 1980 levels. This would reflect windfall profits taxes on the energy industry, increases in both the tax rate and the taxable income base for social security, and the impact of inflation upon effective tax rates. These pressures thus would far more than offset the initial impact of the expected tax-cut package. But at the same time, Federal spending could increase substantially—perhaps

12 percent or so—because of the combined impact of inflation, recession, and increased military spending. Federal spending increased by $85 billion in fiscal 1980—incidentally, an amount equal to the entire Federal spending total of two decades ago— and strenuous efforts will be required to limit the increase in fiscal 1981. The new Administration hopes to shave two percentage points off this fiscal year's increase, but most of the impact of its cuts will be felt in fiscal 1982.

The new team in Washington recognizes that sharp spending cutbacks are essential if we want to reduce the government's excessive demands on the nation's resources. The task won't be easy, especially in view of the bipartisan support for a 25-percent increase in defense spending (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 last spring provided Congress with a list of 58 areas which could yield perhaps more than $230 billion in budget cutbacks over a five-year period. For example, changes in indexing requirements for social-security benefits and other programs alone could yield $70 billion savings over that period.

The dangers of deficit financing can be seen vividly in today's credit markets, where the long-standing threat of "crowding out" may finally become a reality. The danger is aggravated by the presence in the market of a number of "off budget" Federal entities and government-sponsored private enterprises. Altogether, total Federal and Federally-assisted credit demands could exceed $100 billion in this calendar year—almost 30 percent of all credit demands. The markets probably could handle such heavy borrowing demands in a recession period, but the pressures could be overwhelming in the 1980-81 recovery period—as we have seen from the recent upsurge in interest rates. In a word, the Federal government threatens to preempt the loanable funds crucially needed for financing capital formation, while undercutting housing and other interest-rate sensitive industries.

Increasing the Supply of Goods

The national agenda meanwhile calls for a long-term effort to improve the nation's efficiency and increase the supply of goods available in the marketplace. This means, above all, increased emphasis on productivity growth. Now, we should have expected the decline in productivity that occurred during the 1979-80 boom and recession, and we also should have expected the recent recovery-associated upturn in productivity, simply because such movements followed the typical cyclical pattern. But there's no excuse for the long-term downtrend in productivity growth that we've experienced throughout the last decade or more.

These abnormally low increases in productivity largely reflect the use of old, inefficient capital stock. Thus we must stimulate investment as a means of modernizing and expanding the nation's capital resources. And with the enormous increase in energy prices, we must make the capital stock more fuel-efficient. Investment can be stimulated by increasing the investment tax credit, or by reducing tax lives or accelerating depreciation rates, or simply by reducing corporate tax rates. All of these approaches can influence investment decisions, because they reduce the user cost of capital or improve the rate of return. The new Congress thus would be well-advised to implement these various productivity-enhancing measures.

Parallel efforts must be made to develop an energy-efficient economy, and in the process to reduce the massive "tax" imposed on us by the OPEC oil cartel. (The U.S. paid less than $5 billion a year to oil-exporting nations prior to the 1973 embargo, but the oil bill now is roughly $80 billion a year.) Price incentives already have led industry to expand the search for new domestic sources of energy, and have led consumers to adopt rather stern conservation measures. (In this respect, I need only point out that gasoline demand this year will be about 11 percent below the 1978 level.) But with the final dismantling of price controls on the domestic energy industry, I feel confident that we'll make even greater strides in conserving available supplies and augmenting the nation's energy base.

Improving the nation's aggregate supply situation also involves getting rid of the many self-defeating measures that have hobbled the growth of the economy so badly in recent decades. Congress has made a useful start in some respects, by introducing greater competition into the transportation industry and, closer to home, into the financial industry. But our new national agenda requires that we take a closer look at all the "sacred cows" that now overpopulate the range. The list of course is lengthy—including minimum wage laws, farm price supports, protectionist measures for the steel and textile industries, and the many health-and-safety regulations which (despite laudable aims) result mainly in higher costs and lower production.

Concluding Remarks

To sum up, the first item on the national agenda—and the second and third as well—is to stop inflation. We in the Federal Reserve have a key role to play in this effort, by gradually reducing money-supply growth over a period of years. But the Fed can't do the job alone. Because of the uneven impact of monetary policy on various sectors of the economy, a one-sided Fed drive on inflation could seriously harm home builders, small business firms, farmers, and other sectors that rely heavily on bank credit for financing. A balanced attack on inflation thus must involve sharp reductions in Treasury borrowing pressures through a balanced budget, along with the various long-term measures that I've listed to improve productivity and increase competition in the national economy.

There's no reason to be defeatist about the problem. After all, we've fought our way through various inflationary episodes in the past; for example, we were able to cut the inflation rate in half just between 1974 and 1976. But to be successful in the present instance, we've got to reverse some recent trends that have built up a considerable head of steam. The task will be difficult, but the voters have told us that it must be accomplished.