1982 - PROBLEMS AND PROSPECTS

Federal Reserve Bank
of San Francisco
FEB 25 1982
LIBRARY

Remarks of

John J. Balles

President
Federal Reserve Bank
of San Francisco

Luncheon Meeting
San Francisco Chamber of Commerce

San Francisco, California
January 26, 1982

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Federal Reserve needs to continue its policy of reduced money growth in 1982 to dampen inflationary tendencies while the nation is pulling out of the current recession, says Mr. Balles. "But the Federal Reserve cannot do the job alone. Without parallel discipline on the fiscal side, we will be condemned to a continuing cycle of high interest rates and crowding-out of non-Federal borrowers, and to a subsequent decline in the productivity and strength of the U.S. economy."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The Federal Reserve needs to continue its policy of reduced money growth in 1982 to dampen inflationary tendencies while the nation is pulling out of the current recession, says Mr. Balles. "But the Federal Reserve cannot do the job alone. Without parallel discipline on the fiscal side, we will be condemned to a continuing cycle of high interest rates and crowding-out of non-Federal borrowers, and to a subsequent decline in the productivity and strength of the U.S. economy."

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

It's always a pleasure to meet with members of the San Francisco Chamber of Commerce, and I'm especially pleased today to share the platform with the native San Franciscan who's now serving as chairman of the Federal Reserve Bank of San Francisco. Our district is a major part of the Federal Reserve System, geographically and otherwise, and we rely heavily on the advice and support we get from all of our directors on Federal Reserve operations and policy. In particular, we rely heavily on the wisdom and multi-gauged talents of our new chairman, Caroline Ahmanson. And needless to say, her lifelong familiarity with the problems and prospects of the Bay Area make her a special asset to the Federal Reserve System in this difficult period.

My assignment today is to discuss the economic outlook and to tell you how the Federal Reserve fits into the 1982 scheme of things. I might summarize simply by saying that a funny thing happened on the way to the great business boom of 1982. Learned economists told us a year ago that the outlook was quite promising because of the beneficent effects of the government's tax-and-expenditure program. Well, as we've seen, their forecasts were as wide of the mark as the year-old forecasts of who would be playing in the Superbowl last Sunday. Instead of a surging boom, we found ourselves mired in a bad recession and still entangled with problems of high inflation and interest rates. Let me, therefore, review how we got into this mess and how we propose to get out of it.

Underlying Problems

One major task involves dealing with the damage created by a prolonged series of energy price increases. Amid all the recent talk of recessions and recoveries, we should remember that the economy has shown little, if any, growth over the past three years in the wake of the 150-percent

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

oil-price shock of the 1979-80 period. Like the previous shock of the 1973-74 period, this price hike acted as a giant worldwide sales tax, raising prices and draining off purchasing power that would otherwise have been available for purchases of other goods and services. A decade ago, we paid about $5 billion a year for imported oil, but now we pay roughly $80 billion annually. OPEC prices have weakened over the past year, of course, but the earlier shock has continued to boost costs and to disrupt energy-consuming industries, thereby contributing to the overall weak performance of the national economy.

More immediately at hand, we must continue to deal this year with our long-standing problem of severe inflation. This inflation was generated in large part by the Federal Reserve's tendency, prior to 1979, to accommodate a long series of massive Federal deficits through monetizing too large a proportion of them — i.e., through an overly rapid growth of the money supply. The effects can be seen in the doubling of consumer prices during the decade of the 1970s. (Indeed, even at 1981's reduced pace, prices would double again within another decade.) Inflation has undermined the strength of the national economy, for example, by increasing the risk and uncertainty in our business planning decisions, and thus reducing the incentive to invest in productivity-enhancing new plant and equipment. This investment decline creates a vicious circle of rising labor costs which support further surges in inflation, which further undermine investment and growth.

Monetary Policy Factors

In the present recession, many analysts downplay the influence of other underlying factors and instead point to tight Federal Reserve policy as the major cause of the business decline. There is no doubt that any shift in policy has undesirable side effects, just as penicillin does in dealing with some severe illness. In this connection, it's crucial to note the different lags involved in the application of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

monetary policy. In brief, a tight monetary policy, with slow money growth, means that the bad news comes first and the good news comes later. That is, a tightening of policy means a slowdown in the growth of credit, employment and income, generally within a half-year or so, while the good news of decelerating inflation takes another year or more to arrive. In contrast, an easy monetary policy sends us the good news first in the form of a rise in business activity, and the bad news somewhat later in the form of an acceleration of inflation. Most people, including most political figures, have a somewhat short time horizon. So you can see that a tight monetary policy can be quite unpopular at the time the bad news is evident and the good news is still on the horizon.

In this inflationary period, the Federal Reserve has found the money supply to be the most reliable guide to monetary policy. Most economists now agree that inflation is primarily, but not exclusively, a monetary phenomenon. To reduce inflation, in other words, we must reduce money growth gradually over time. Thus, in October 1979, the Federal Reserve changed its operating procedures to provide better control over the growth of the money supply. Our old operating procedures certainly helped to stabilize interest rates in the short run, but they led to systematic over-shooting of our money-supply targets and to subsequent double-digit inflation. In turn, this led to double-digit interest rates. The new procedures, although allowing interest rates to be determined largely by market forces, have given us better control of the money supply on a year-to-year basis.

The narrow M-1B measure of money — currency plus all transaction (checkable) deposits — has decelerated significantly in recent years, to five-percent growth in 1981 from 1978's eight-percent growth (see Table 1). But some economists instead point to the growth of the broader (M-2) monetary aggregate, which has not slowed at all in the past two years. (This aggregate includes M-1 plus such additional items as small-denomination savings deposits

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

and money-market mutual funds.) Hence such critics argue that the Federal Reserve has not really had a very restrictive policy since the adoption of its new operating procedures in 1979. But most economists — and certainly the evidence we see around us — argue that the M-1B measure is a reliable guide to policy and that the Federal Reserve has in fact become progressively more restrictive in recent years.

Table 1

Percentage Growth of Monetary Aggregates

(4th Quarter of Preceding Year to 4th Quarter of Year Indicated)

	M1B*	M2**	M3***
1975	5.1	12.3	9.4
1976	6.1	13.7	11.4
1977	8.2	11.5	12.5
1978	8.2	8.3	11.2
1979	7.5	8.8	9.8
1980	7.2	9.6	10.2
1981	5.0	9.5	11.2

*M1B equals currency plus demand deposits plus travelers' checks plus other checkable deposits (OCD) at banks and thrift institutions. After 1981, M1B will be designated as M1.

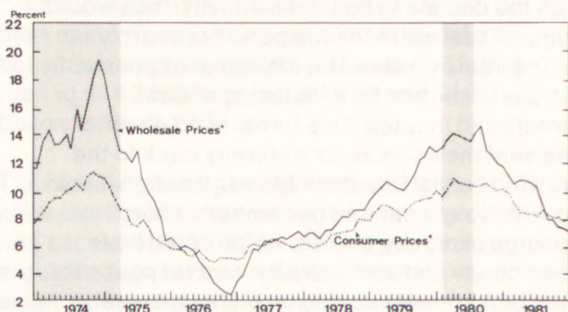
**M2 equals M1B plus overnight repurchase agreements (RPs) and Eurodollars, money-market fund shares, and savings and small time deposits at commercial banks and thrift institutions.

***M3 equals M2 plus large time deposits and term RPs at commercial banks and thrift institutions.

Consequently, the good news of tight money is now becoming more evident (see Chart). Wholesale prices rose at a 15-percent annual rate in the year ending August 1980, but at only a seven-percent rate over the past twelve months. Similarly, consumer prices (as measured in the GNP accounts) decelerated from a 10½-percent rate of increase in March 1980 to less than an eight-percent rate in late 1981. We can confidently expect the inflation rate to continue declining in 1982 on the basis of the restrictive monetary policies implemented since October 1979.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

MEASURES OF U.S. INFLATION
Percent Change in Prices Over One Year Earlier



Shaded area indicates a recession as defined by the National Bureau of Economic Research.

*Percent change in prices from indicated month of previous year to indicated month of current year. Wholesale price series is the Producers' Price Index. Consumer price series is the Personal Consumption Expenditure Deflator.

As I said earlier, the bad news of tightening monetary policy also can be seen all around us, in terms of the sluggishness of real GNP for the last three years and the current business-cycle contraction. However, we cannot blame the exceptionally high interest rates of recent years entirely on Federal Reserve policy. We should remember that interest rates are determined by many factors — including, but not mainly, the actions of the Federal Reserve, which can control only the supply of money and not the demand.

Certainly the Fed can affect rates in the short run, because of its efforts to control the amount of reserves in the banking system and the amount of money in the hands of the public. But business-cycle conditions also influence rates, as credit demands rise and fall with the cycle. And above all, price expectations heavily influence rates, frequently offsetting other market influences. If, for example, people expect prices to rise by (say) 10 percent a year, lenders will demand that 10-percent inflation premium plus some real "underlying" interest rate of perhaps three to four percent, to protect themselves against an expected loss in the purchasing power of their money.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Interest Rates and Money Growth
The recent decline in the inflation rate, along with the decline in business activity, thus would suggest that we're in for a period of sharply falling interest rates. But look what happened in the past month or so, with its significant turnaround in rates. This turnaround obviously has sent the economics fraternity back to the drawing board. One possible explanation has to do with November and December's sharp upsurge in money growth, which could have been construed by our critics as a response to their demands for easing up on the monetary brakes. Now, many economists believe that such action normally would increase the liquidity of the economy and put downward pressure on interest rates. But this late-1981 episode, as well as several earlier episodes of the past two years, now indicate that sharp upsurges in money growth may perversely lead to **increases** in interest rates. Indeed, this in fact happened in December, following several months of declining rates.

A new school of economics, called the rational-expectations school, may have an explanation for this strange turn of events. I won't go into the details, but the theory seems to say (in the words of that famous economist Abraham Lincoln) that you can't fool **all** of the people **all** of the time. In other words, the millions of people investing in U.S. financial markets have begun at last to learn some hard-earned lessons from the inflation experience of the 1970s. To repeat, we used to think that we could ease recessionary pressures through a switch to monetary stimulus and consequent drop in interest rates, but this recent experience suggests that we cannot count on that result any more. Instead, sharp increases in money growth lead market participants to push rates up (rather than down) because of increased fears of future inflation.

Interest Rates and Deficits
We should not overlook, however, a second major reason for the recent upsurge in interest rates — namely, Federal deficit-financing pressures. You may remember that the December increase in interest rates occurred almost simultaneously with the leaking of the news about a sharp and unexpected rise in

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Federal-deficit forecasts over the next several years. Until early December, $43 billion was the "official" forecast of the fiscal 1982 deficit. But then came the shocking news that the deficit could actually rise to $109 billion in 1982, and then to $152 billion in fiscal 1983 and $162 billion in fiscal 1984.

Theoretically, rising budget deficits don't necessarily lead to accelerated money growth and accelerated inflation. Indeed you could argue that our budget deficits are relatively small by international standards, when measured in relation to total production. This is true, but unfortunately our savings rate is also low by international standards, and it is the relation between the two measures that is crucial. In the last half-decade, for example, U.S. net savings amounted to less than five percent of the nation's total output. In contrast, the savings ratio was more than twice that large in most major European nations, and almost four times that large in Japan. In this connection, incidentally, I would warn our overseas friends that continuation of their large deficits over the next several years may boost their overall debt ratios to levels comparable with ours. In other words, they may be only a few sips of the bottle behind us, and may soon find themselves faced with the inflationary DTs as we are today.

Large Federal deficits in the next several years may not create financial chaos, but they certainly would aggravate our present economic problems. Continued deficits put pressure on product markets, making prices increase faster than they otherwise would. The Federal Reserve may be able to prevent a significant rise in inflation by allowing interest rates to remain high, but this would tend to "crowd out" private spending. Moreover, such a policy could seriously strain Congress' tolerance of high interest rates. As a result, Congress could make strong demands on the Fed to resume the policy of accommodating Federal deficits through higher monetary growth — even though it might exacerbate inflation.

But even if the inflationary effect is small, sustained deficits would tend to crowd out private investment in the economy. In fiscal

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

1981, the nation generated about $185 billion of savings — the amount available to add to our plant and equipment, to inventory, to housing, and also to finance the Federal government. But Federal deficit and "off-budget" financing, when combined, totalled more than $80 billion — nearly one half of the nation's total savings. And this year, for the first time in the past generation, the government deficit will probably exceed the nation's entire net outlay for new plant and equipment. In recent years, net private investment has amounted to only six percent of Gross National Product. A rise of the deficit by another two percent of GNP — the amount suggested by recent deficit estimates — could reduce net private investment by one-third of its current value, to just four percent of GNP. Ironically, this would tend to offset all the stimulus to business investment created by the 1981-82 tax reductions.

Many bright minds in Congress and in the Administration will be addressing this problem in the next several months, beginning with the President's State of the Union message tonight. They have a wide menu of choices, including increases in taxes — or revenue enhancements, if you will — and reductions in various spending components. On the spending side, we should remember that what goes up can come down, at least in relative terms. One perceptive observer, Martin Feldstein, recently noted that most of the major increases in Government spending were of fairly recent vintage. Federal civilian spending, as a share of GNP, rose from nine percent in 1960 to 13 percent in 1970, and finally to 17 percent in 1980. Returning such spending to the 1970 share of GNP, which is hardly a drastic cutback, would reduce outlays by four percent of GNP, or $160 billion at the 1984 level — that is, by enough to eliminate the entire deficit. Such a cutback is unlikely, of course, but the figures indicate that there is still some room for a rollback of rapidly expanding programs. On the revenue side, I hold no brief for any specific increases, but will simply note a few of the measures that some Congressional leaders are now proposing — such as excise-tax boosts, windfall-profit taxes on decontrolled natural-gas prices, or perhaps a stretch-out of

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

the last 10 percent of the personal income-tax reduction.

Concluding Remarks: Recession and Inflation
You have probably noticed that I've allocated almost all of my alloted time to a discussion of the continuing problems of inflation and high interest rates, and have not discussed how we're going to overcome the current recession. This doesn't indicate any hard-hearted lack of concern about the severe problem of unemployment, but rather a conviction that unemployment can be cured only through an attack on the basic problems that I've mentioned. Otherwise, we will condemn ourselves to ever-rising unemployment in a continuing and perhaps worse series of recessions.

We can be reasonably confident about overcoming the present recession, moreover, because of the automatic nature of the economic processes now at work. In an automatic cyclical fashion, increased orders and increased employment should result as businesses run off their present excess inventories and are forced to reorder new materials and equipment. Also, in an automatic stabilizing fashion, the downward spiral should be neutralized by the fiscal reforms of the past generation — the automatic reductions in income-tax receipts and increases in unemployment compensation and social-security benefits that go along with any downturn in production and employment. These automatic processes, plus the fiscal stimulus developing from the 1981-82 tax reductions, should lead to an upturn in the economy as we move further into the year.

Although we can be confident about overcoming recession, we must be more cautious about dealing with the ensuing recovery. Today we are faced with the same type of situation that confronted us in the 1975-76 period. On that earlier occasion, strongly stimulative fiscal and monetary policies led to a strong recovery from recession, but at the cost of resurgent inflation. Moreover, financial markets are skeptical about our ability to do better in today's similar situation,

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

judging from the upsurge in interest rates which greeted the recent increase in monetary growth and the expectation of continued massive deficit financing.

To deal with the markets' fears, the Federal Reserve must continue to carry out its game plan of reduced money growth, and thereby add credibility to the nation's anti-inflation program. But the Federal Reserve cannot do the job alone. Without parallel discipline on the fiscal side, we will be condemned to a continuing cycle of high interest rates and crowding-out of non-Federal borrowers, and to a subsequent decline in the productivity and underlying strength of the U.S. economy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

judging from the upsurge in interest rates which greeted the recent increase in monetary growth and the expectation of continued massive deficit financing.

To deal with the markets' fears, the Federal Reserve must continue to carry out its game plan of reduced money growth, and thereby add credibility to the nation's anti-inflation program. But the Federal Reserve cannot do the job alone. Without parallel discipline on the fiscal side, we will be condemned to a continuing cycle of high interest rates and crowding-out of non-Federal borrowers, and to a subsequent decline in the productivity and underlying strength of the U.S. economy.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

Dup

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis