

RECESSION AND RECOVERY

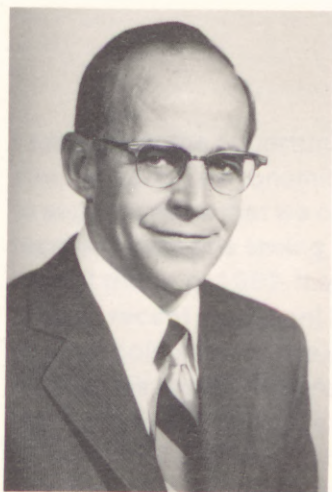
Remarks of

John J. Balles

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

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The U.S. economy is strengthening because of such factors as a sharp decline in the inflation rate, says Mr. Balles. Nonetheless, a substantial recovery cannot be assured in the present atmosphere of high interest rates. The obvious solution would be a sharp cut in prospective Federal deficits. This would reduce long-run inflation expectations — and the result would be a lowering of long-term rates, which would then help to lower short rates as well. Thus, he concludes, a sustainable recovery requires a move toward fiscal discipline, as well as a continuation of the Federal Reserve's current policy of monetary discipline.

**Federal Reserve Bank
of San Francisco**

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I appreciate the opportunity to discuss with you the nation's economic difficulties, and to suggest ways that we can return to the recovery path this spring, following the dismal winter of 1982. It might help for us to recall a recent statement by a **Wall Street Journal** columnist, to the effect that recessions are like Wagnerian operas — they eventually come to an end, despite whatever we may think while we're in the midst of them. So let me review the forces leading toward a recovery, as well as the obstacles that might yet thwart that recovery.

Role of Directors

Before I do so, I'd like to pause to pay tribute to those strong individuals who have helped immeasurably with advice on our policies and operations — the directors of the Federal Reserve Bank of San Francisco. 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 Monetary Control Act of 1980, the Federal Reserve is moving into a new operating environment. Over the past year, the Fed has been making its services available to all depository institutions offering transaction (check-type) accounts and nonpersonal time deposits, and those services are being 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 Western industries and in various regions of our nine-state district. Our directors thus help us anticipate changing trends in the economy, by providing insights into consumer and business behavior which serve as checks against our own analyses of statistical data. Their advice has been especially valuable to us these last several years, when we've had to face problems of high inflation, high interest rates, and sharp fluctuations in business activity.

Conflicting Indicators

We need all the advice we can get, because we are faced today with one of the worst recessions of the past generation — or perhaps I should say series of recessions, because after several ups and downs, the nation's output is no higher now than it was three years ago. Part of the problem lies with the 150-percent oil-price shock of the 1979-80 period, which acted as a giant

sales tax, raising prices and draining off purchasing power that otherwise would have been available for buying other goods and services. But the major cause of the problem must be inflation itself, which for a decade has undermined business and consumer spending plans, leading to a decline in productivity and in the general health of the U.S. economy. In addition, the successful anti-inflation program of the past several years, with its tightening of monetary policy, has clearly achieved its goal but at the temporary cost of a reduction in business activity.

Recent statistics have provided a field day for the doom-and-gloom school. Gross national product, in real terms, has declined at a 4-percent annual rate or more for two quarters in a row, and some analysts predict a further decline during the spring months. The monthly purchasing managers' survey found no evidence of an upturn in March, as production and new orders continued to decline. The economy has lost more than one million jobs since last summer. Nine percent of the civilian labor force were unemployed in March — the highest level of the past generation — and Administration spokesmen concede that the jobless rate may still be in that range at yearend.

Equally worrisome is the shaky liquidity position of many households, businesses, financial institutions and governments. For example, Federally insured savings-and-loan associations may suffer a record \$6-billion loss this year on the heels of last year's \$4½-billion loss, reflecting the widening gap between the cost of S&L funds and the yields on their home-mortgage portfolios. Behind all these problems is the extremely high level of real

(inflation adjusted) interest rates. These record rates threaten to choke off business investment, and have already seriously undermined the health of housing, autos and other interest-sensitive industries. I'll have more to say on that subject in a minute, because high interest rates represent the strongest threat to a significant recovery.

Nonetheless, favorable signs are just as easy to find as unfavorable statistics at this juncture. More than 99 million people now have jobs. That amounts to more than 57 percent of the adult population — two percentage points higher than during the last recession, and indeed, a higher figure than at any other time prior to the 1978-79 boom. Also, households' take-home pay (adjusted for taxes and inflation) has remained high during this recession, which means a stable floor under consumer purchasing power. Much of this improvement reflects the obvious deceleration in inflation — another matter which I will discuss further in a minute, because it represents by far the most favorable element in the current outlook.

Some financial statistics also provide us with grounds for optimism. Over the past three years, the burden of mortgage-plus-instalment debt has dropped from 28 percent to 25 percent of consumer after-tax income. Also, the percentage of delinquent instalment loans is lower now than during either of the last two recessions. The corporate debt picture admittedly looks bleaker, with the sharp decline in the ratio of long-term to short-term debt. However, much of this short-term debt is automatically renewed under bank credit lines. According to the **Wall Street Journal's** Alfred Malabre, companies in effect are now

obtaining long-term credit at variable rates, which could prove less burdensome in a period of decelerating inflation than the usual type of fixed-rate long-term debt.

Process of Recovery

With such a diverse mix of favorable and unfavorable indicators, how can we confidently expect any sort of second-half upturn? Basically, we should remember that every recession carries within itself the seeds of the ensuing recovery. This is especially true of the inventory liquidation-and-restocking process. Businesses reduced their inventories during the first quarter at about the same pace as during the record cutback of early 1975. Inventory cuts of that magnitude cannot continue very long when final sales remain stable, as they have been recently.

The second major factor underpinning the recovery will be consumer buying, which normally accounts for about two-thirds of total GNP. With the recent stability of consumers' real income and with relatively favorable burdens of consumer debt, households are set to continue their recent three-percent rate of expansion of real purchases. After midyear, paychecks will be boosted by the income-tax cut, and that will add some \$35 billion a year to spending and saving power. The annual inflation escalator in social-security benefits should add over \$11 billion more at the same time.

In the investment field, we may experience at least a modest boost in spending as the year progresses. Given the current high level of mortgage rates, few analysts expect the pace of homebuilding to exceed a 1.2-million rate of starts by yearend. That

normally would be a very sluggish pace of activity for such a key industry, but it represents a 40-percent increase from the recent low. In business investment, the current high level of idle capacity has tended to offset the supply-side incentives of faster depreciation write-offs. Recent surveys thus indicate that 1982 investment outlays, adjusted for inflation, will roughly match last year's outlays. But 1981 was a near-record year, which means that we are seeing a sturdy level (rather than a weakening) of corporate spending in a recession period.

Government spending (except for defense) is unlikely to provide much support for the economy in the coming period, which of course is not the usual recovery pattern. For the first time in the past generation, state- and-local government spending is actually declining instead of rising as it normally does. But defense spending of course will be rising strongly, to give a boost to the overall economy.

Turning to the regional outlook, my first tendency is simply to say that California will (as usual) outpace the national economy. I can't say that with too much confidence, however, considering the fact that the state has been hit harder by recession than any of us had anticipated. Aerospace manufacturing, agriculture, and construction — the major industrial mainstays of California's economy — have all had their troubles recently. As a result, we've experienced a loss of more than 100,000 jobs since last summer, and now see a jobless rate a half-percentage-point above the U.S. average.

Nonetheless, with all of California's problems, the outlook generally appears stronger here than in the nation as a whole. For example, the state will benefit from the Pentagon's 30-percent increase (in real terms) in procurement and research-development expenditures this fiscal year, because of the state's predominance in those areas. Agriculture and commercial construction will probably move sideways, and the depressed housing industry may yet stage a modest recovery. On the other hand, poverty-stricken state and local governments can provide no support to the impending upturn. But by the same token, the crucial household sector should support the recovery because of its reduced tax burden — including the current Federal tax cuts, plus the effects of earlier California innovations such as Proposition 13 and income-tax indexing.

Lower Inflation: Boost to Recovery

Yet for both the state and the nation, the recent deceleration of inflation represents the best possible news in the business outlook. (After all, each percentage-point decline in the inflation rate represents about two-thirds as much of a boost to real household income as we'll receive from the midyear tax cut.) Consumer prices have increased at only a three-percent annual rate over the past half-year, which is roughly one-third the pace of last year, and only one-fourth the pace of the two preceding years. Moreover, crude-materials prices at the producer level have actually **declined** more than four percent over the past year — and that portends well for continued deceleration of prices at the retail level.

Part of the price improvement can be traced to the worldwide oil glut. World oil prices have dropped about six percent from the early-1981 peak, and could drop just as much later this year even in the face of reduced OPEC production. Another part of the improvement can be traced to a weakening of labor-cost pressures — as typified by the Ford and General Motors settlements, where large layoffs and mounting losses have forced labor to accept wage freezes and less frequent cost-of-living increases. Average wage gains thus could amount to about seven percent this year, as compared with last year's nine-percent increase.

Most of the favorable inflation news, however, can be traced to a policy of monetary discipline, since inflation is primarily a monetary phenomenon. The narrow M-1 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. And since monetary changes affect prices with roughly a two-year lag, we're now seeing the favorable results of the monetary slowdown adopted several years ago.

For 1982, Federal Reserve Chairman Volcker announced in February an M-1 growth target of 2½ to 5½ percent. But as he told Congress, an outcome in the top half of that range would be acceptable, in view of last year's relatively slow growth. Indeed, the real (price-adjusted) money supply has increased on balance since the recession began, thus ensuring that monetary policy will dampen rather than aggravate the economic downturn. But consolidating and extending the heartening progress on

inflation will require continued restraint on money growth, and the Fed intends to maintain the necessary degree of restraint. Policy thus is designed to support long-term non-inflationary growth, rather than a roaring inflationary boom.

High Interest Rates: Recovery Roadblock

Yet all of the favorable factors in the outlook could be negated by the roadblock thrown up by the high interest rates of the past several years. Typically, at this stage of a decelerating inflation, we would have seen a dramatic decline in interest rates, primarily because of the disappearance of the inflation premium formerly demanded by lenders. A few statistics will show the very close relationship between the inflation rate and interest rates in recent decades. In 1964, the inflation rate was 1.2 percent and the Treasury-bill rate 3.6 percent. With the ensuing inflation, in 1974 the inflation rate rose to 12.2 percent and the T-bill rate to 7.9 percent — but two years later, the inflation rate was down to 4.8 percent and the T-bill rate to 5.0 percent. With the next burst of rising prices, the inflation rate reached 13.3 percent in 1979 and the T-bill rate jumped to 10.0 percent. But then, in the first quarter of 1982, the inflation rate fell to 3.7 percent — and the T-bill rate averaged 12.9 percent.

This year, therefore, interest rates have reached record levels when allowance is made for declining inflation. This has made business financial statements very depressing to read. For example, net

interest costs of nonfinancial corporations jumped almost by half in two years' time, to \$64 billion in 1981. And high interest rates have stymied the usual cyclical upturn, especially in the key housing industry — which normally leads each upturn, but which cannot recover at today's mortgage rates of 16 to 17 percent.

At the beginning of the year, some critics attributed the high rates to a sudden and temporary upsurge in money growth, which they interpreted as a Federal Reserve capitulation to easy-money pressures guaranteed to unleash a new outburst of inflation. The money-supply bulge later levelled out, and yet interest rates remained very high. This suggests that we should look to another explanation of the rate upsurge — namely, the unexpected magnitude of Federal deficit-financing pressures. Early this year, the Administration projected an aggregate deficit for the 1982-84 period of \$273 billion — far more than anticipated — while the Congressional Budget Office claimed that the three-year total could reach \$454 billion under current tax and spending legislation.

The massive deficits now facing us have kept inflation **expectations** very high, despite the significant decline in the actual inflation rate over the past two years. The markets obviously fear that at some point, the Fed might begin a sustained program of monetizing the massive deficits. This would lead to an excessive expansion of the money supply, followed within the next two years by a renewed upsurge of double-digit inflation.

Large Federal deficits in the period ahead certainly would hamper our attempts to stage a sustainable business recovery — and in the worst case could lead to financial chaos. The Federal Reserve indeed may be able to prevent a significant rise in inflation by allowing only slow growth in the money supply. However, in the face of a relatively low savings rate and huge Federal borrowing, interest rates would stay high and “crowd out” private borrowing. I’ve been emphasizing this point for the past several years, somewhat like the little boy who kept yelling “wolf.” But now we all see that the crowding-out phenomenon has finally arrived, and with a vengeance. The strongest evidence can be found in the home-mortgage market, of course, but other signs are equally evident — such as the focusing of corporate credit demand on the short-term market, resulting in congestion and high interest rates there.

According to Administration estimates, Federal borrowing from the public — including both deficit financing and “off budget” financing — could rise from \$79 billion in 1981 to \$115 billion in 1982. This represents the culmination of an important trend in the nation’s financial markets. Federal borrowing amounted to 16½ percent of total funds raised in credit markets during the 1970’s, with the share increasing during recession years. But now, according to our staff estimates, the share could approach 32 percent in the 1982 recession year and 26 percent in the 1983 recovery year. Clearly, this overwhelming Federal presence in credit markets has affected the amounts available to finance state and local governments, business needs for plant-equipment and inventory — and, needless to add, the auto and housing

markets. The essential needs of these crucial sectors of the economy thus can be met only at very high levels of real interest rates.

The appearance of runaway budget deficits, perhaps predictably, has led to a severe reaction at the state and local level. As of now, 31 state legislatures have petitioned Congress to call a convention to consider a balanced-budget amendment to the Constitution — and the votes of only three more states would be needed to trigger the convention call. The opponents of this approach argue that it would straight-jacket the fiscal-policy process. In any event, the discussion about a constitutional amendment may play a useful role in getting badly-needed fiscal discipline. Indeed, both houses of Congress are now considering balanced-budget amendments which parallel the language adopted by many state legislatures. Still, the best way for the Administration and the Congress to counter this somewhat rigid approach would be to take specific action, on both the revenue and expenditure sides, to bring the budget closer into balance today. In a recent report, the Congressional Budget Office listed 69 “budget reduction options” and 40 “options to increase tax revenues.” I’m sure that Administration and Congressional leaders have thoroughly studied every one of those bullet-biting options. What they need is the political skill to assemble a package of workable measures that will remove the deficit threat to our economic and financial health.

As central bankers, it is not our responsibility to propose specific measures to close the fiscal gap. Still, we have a responsibility to point out the implications

for financial markets of the crowding-out process created by heavy deficit-financing pressures. Thus, I believe that there must be a major reduction in the size of prospective Federal budget deficits if there is to be any hope of a significant decline in the level of interest rates — and I'm glad to see that Treasury Secretary Regan made the same point in a recent television interview. Such a decline in rates is badly needed to set the stage for a healthy recovery in the national economy. The country thus anxiously awaits signs of a compromise ending the present deadlock between the Congress and the Administration on measures to reduce the budget deficits.

Concluding Remarks

In sum, we can be reasonably confident about an upturn in the national and regional economies, given the working-out of the inventory-liquidation process and the many signs of strength in the underlying economy. The most obvious sign of strength is the sharp drop-off in the inflation rate, which has stabilized real incomes and begun to restore confidence to household and business spending/saving decisions. Nonetheless, a substantial recovery cannot be assured in the present atmosphere of high real interest rates.

The obvious solution is to cut prospective deficits very sharply. This would reduce long-run inflation expectations — and the result would be a lowering of long-term rates, which would then help to lower short rates as well. In a word, then, a sustainable recovery requires a move toward fiscal discipline, as well as a continuation of the Federal Reserve's current policy of monetary discipline.

