

PREPARED FOR GOVS CALL ON C/E 29.7.82

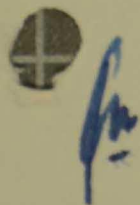
⊕ GOVS CALL ON P/M - copy in 28. 7.82
S.41/1. Sec.14.

THE GOVERNOR'S PRIVATE SECRETARY

I attach, as requested by the Governor, draft speaking notes on US economic policy and possible implications and problems for the US and the world economy. In each case the speaking point is underlined and followed by supplementary material on the theme.

International Division
28 July 1982

C M Watson (4825) HO-3



THE GOVERNOR'S PRIVATE SECRETARY

USA: TALKING POINTS

A Economic Background

- 1 The policy of monetary restraint is being maintained, and - despite disagreements about technique - the Administration is firmly supportive of this.
- 2 The Administration saw the importance of setting market forces to work in the economy. However, they underestimated very seriously the time it would take for unionised labour - and often management - to take a realistic view of the changes that firm monetary policy, a high exchange rate and deregulation would imply for costs in industry. Despite some significant concessions in manufacturing industry and transport early this year, adjustment in the traditional sectors is still much too slow. Unemployment will stay high.
- 3 Because expectations have been slow to adjust, tight money has reduced inflation very much at the expense of economic growth. GNP in Q2 1982 was no higher than in Q1 1979; this year it is likely to grow by no more than 1%, Q4 on Q4.
- 4 Low growth has made the budgetary problem much worse. On a realistic basis the deficit in FY 1983 (= October 1982-September 1983) is likely to be \$130-160 bn: on 50-60% of personal saving. It has also been very hard to reduce basic social spending while building up defence and (modestly) reducing taxation. It is going to be very difficult to cut back the deficits even when private sector demand picks up.
- 5 So monetary policy has borne the burden of restraint and is likely to continue to do so. Volcker's mid-year testimony made clear that monetary reflation is not in prospect - although he noted that in the short run the money numbers could be distorted up or down. Interest rates have been high and are likely to stay

relatively high. Part of this - especially at the long end - is a fear that the fiscal problem is out of hand and that inflation will reaccelerate sharply next year. Three-month Treasury bills averaged some 12.62% in the first half of this year, and ten-year Treasury bonds averaged 14.11%. At the moment inflation has come down to about 6-7%, and with luck will stay at this level.

13 1/2
13 7/8
13 7/8
13 1/2

6 The present quarter is seeing a window in short-term interest rates as M1 growth fell back in late June. However, economic growth is probably picking up to about 3% in the second half while Treasury borrowing is going to be very high. This is likely to cause short-term interest rates to begin to rise again to some extent by Q4. Long-term interest rates have only improved by 1/4 as much as shorts in the last month. Between 28 June and 26 July three-month Treasury bills fell from 13.70% to 10.81% while 10-year Treasury bills fell from 14.67% to 13.94%. At the moment inflation has come

7 In summary the prospect for the rest of this year, and probably next, is for growth close to trend (3% or a little less) - but this starts from a level at which capacity utilisation is low (69.8% in June) and unemployment high (9.5% in June) - extremely high in some cities and amongst racial minorities. There is a worry that monetary policy is - if anything - too tight, to compensate for the prospective looseness of fiscal policy. This policy mix means interest rates have been and will be rather higher than they need be.

B Implications for the United States

1 With a sluggish recovery and persistent high interest rates the fabric of confidence is now very taut indeed. This is true at three levels:

- The consumer is affected by anxiety about unemployment, a very weak housing market, and to some extent (despite deposit insurance) by failing thrift institutions. Nevertheless the average consumer has considerably less debt in relation to his income than three years ago, has already deferred

replacing durables for some time, and will probably spend, not save, his July tax cut. [/The tax cut and other changes will add some 1% to PDI over the year ahead.]

- In most sectors of the economy (except services, defence, electronics) business corporations are in a poor shape. The maturity of their debt has continued to shorten, interest ~~costs~~ costs are a heavy drain on cash flow, and - most importantly - they face a much slower economic recovery than in any cycle in the post-war period. Overheads and labour are being cut back. Capital spending is being limited to light investment, aimed at process improvements not new plant. Many firms will no doubt come through with much improved capacity to compete. [/Even in steel - which is suffering its worst recession since the 30s - the non-unionised mini-mills are doing very well and increasing their share of the market.] However, the heavy industrial sector - whose labour is strongly unionised, and whose sales are very interest sensitive - is not in shape to survive a slow recovery. There is a clear possibility of numerous and serious bankruptcies in the traditional industries - which are very much concentrated in the North-East and Mid-West.
- The banks are now alive to the serious credit risks in these industries and others which have been especially strongly affected by high interest rates and/or deregulation: in particular trucking, airlines, housing, forest products. Their diagnosis is a need for more selectivity in lending, higher rewards for riskier lending, closer "relationship banking" with their clients. At this point however the competition in the bank lending market remains intense. [/This competition is principally driven by foreign banks and large money centre banks from California, New York and Chicago (and indeed commercial paper dealers) whose almost exclusive objective is market share in the nationwide wholesale dollar market.] In other segments of the banks' business powerful competition is also either present - eg, from money market funds -

or potential - from large thrift institutions (which are beginning to do rescues across state lines), cash management accounts (which offer many banking services to upper market individuals) and retailers such as Sears (which are entering the personal financial services market at the lower end). So the banks are still being driven to lend at very fine spreads and to move further away from relationship banking towards "transactions banking". There are some advantages in this of course: large (but not small) companies obtain finer rates, and credit risk is spread through the system. In a sense, also, the process of deregulation, change, innovation, consolidation of institutions, testing of legal limits on business is strategically healthy and attractive. However, the speed with which change is occurring - against a background of increasing domestic and international credit risk - does not help confidence in the system. The volume of uninsured money market fund deposits is now over \$200 bn or equivalent to 45% of M1 (they are not in M1), and this is a specific example of risk in the system increasing. The question arises also whether wholesale lenders (foreign or "out of state") will prove fair-weather friends only: whether the dispersion of risk is real. It is notable, finally, that some major US banks are reducing their limits on other majors which have experienced unexpected losses - not a healthy sign.

3 While the risks in the system, economic and financial, are increasing, failures so far have been amongst institutions which were either exceptionally aggressive and highly geared or victims of gross mismanagement and fraud. So pessimism can be overdone. Provided any problems which arise are handled with the right blend of toughness and financial containment there need be no wider loss of confidence.

4 In summary, the process of disinflation in the US is proving long-drawn out and painful. Expectations of inflationary growth have had a long way to adjust. So far the consumers, industry

and the banks have weathered the storm reasonably well. Few genuine alternatives to the present policies command any appeal. However, confidence is now becoming rather more fragile. A resumption of growth at a rate of about 3% will help here, but it may not be rapid enough to prevent serious financial difficulties in the heavy industrial sector.

C Implications for the World Economy

1 There is a need to be discriminating in assigning blame for the world's economic ills to US policy. We have always advocated firm monetary policy in the US, and we believe that large areas of the economy can benefit over time from well judged deregulation. Many countries suffer independently from parallel economic problems to those manifest in the US and may need positive real interest rates and market liberalisation to address them.

2 Nevertheless the failure of the United States to achieve convincing fiscal control is lamentable. An improvement in this area - notably a phased increase in revenues in FY 1983-85 and acceptance by the President and Congress of cuts in expenditure areas hitherto regarded as sacrosanct - would promise a material easement of a number of problems in the United States and in the World economy. It would diminish considerably the risks inherent in the present situation.

3 The areas of benefit from improving the policy mix should be:

- A somewhat lower level of interest rates: the effect on expectations of an improvement in fiscal policy is unquantifiable but at the longer end of the bond market could be considerable, and it would be helpful in increasing the room for manoeuvre of policy in many other countries.

- Because of the lower level of interest rates the US dollar might decline to a level somewhat closer to the level suggested by competitiveness measures. This would be helpful

(a) in reducing the extreme competitiveness of imports (especially Japanese imports) in the US and hence pressures for protection;

(b) in reducing the risk of a "roller coaster" effect in which the period of exceptional strength of the dollar, and a sharp deterioration in the US external account, could be followed by a sudden and disturbing fall in the dollar.

- Because the lower level of interest rates should contribute to stimulating investment in the US and - directly or indirectly - in other countries.

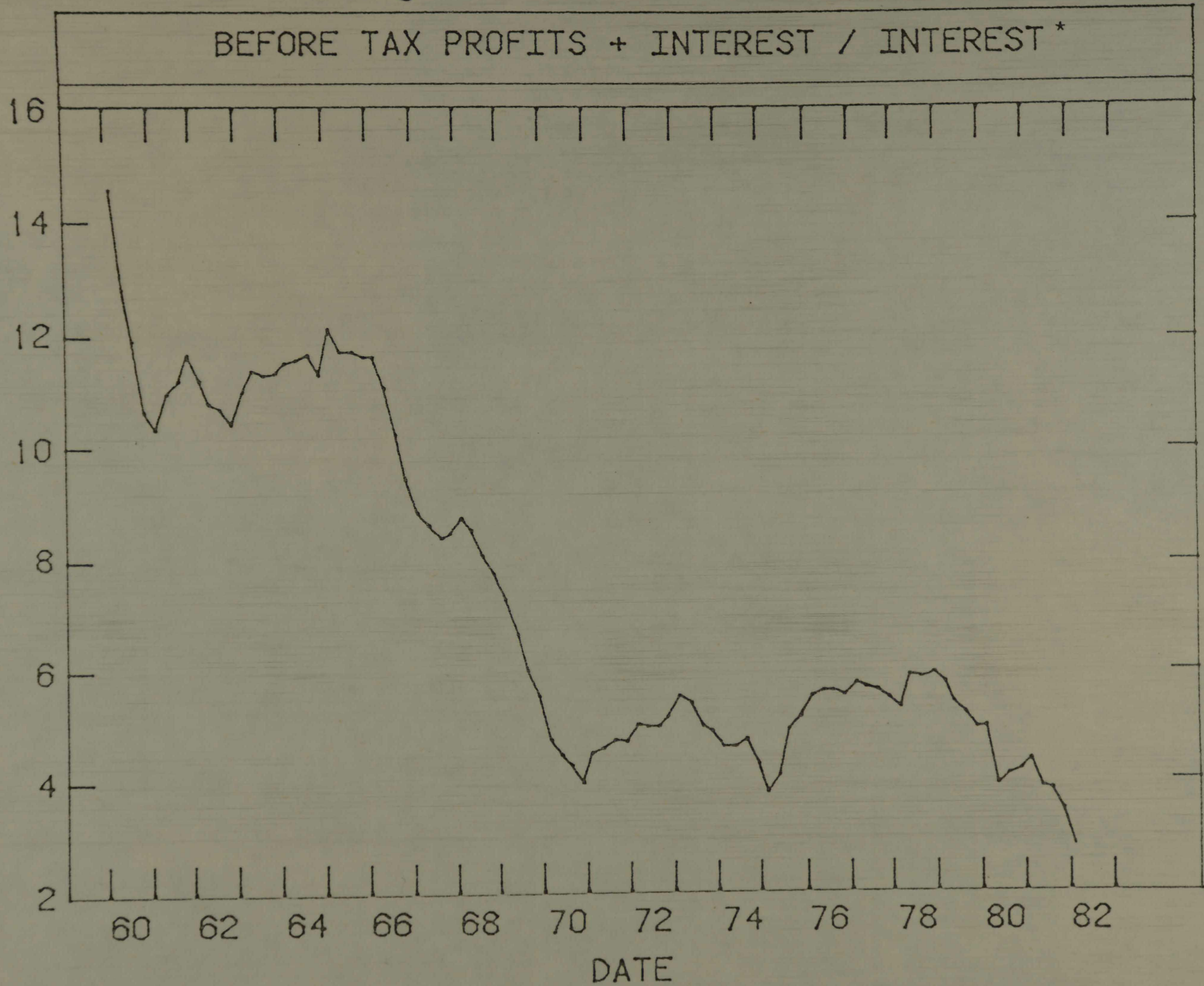
- Because it should foster market conditions in which corporations could more easily improve their financial structure by funding their debt - which, given the interlinking of the dollar market, would reduce risk in the banking systems in the United States and abroad.

- In more general terms, because it would diminish suspicion in the United States that lax fiscal policy will come to cause easy money. To the extent this lowered inflationary expectations and strengthened wage and other cost improvements in the US, it could allow resumption of growth at a somewhat higher rate in the period immediately ahead, with direct benefits to the world economy. In brief, uncertainty is an enemy of growth, and enterprise, and we know that the apparently conflicting signals from fiscal and monetary policy cause uncertainty about longer-term policy to a very high degree.

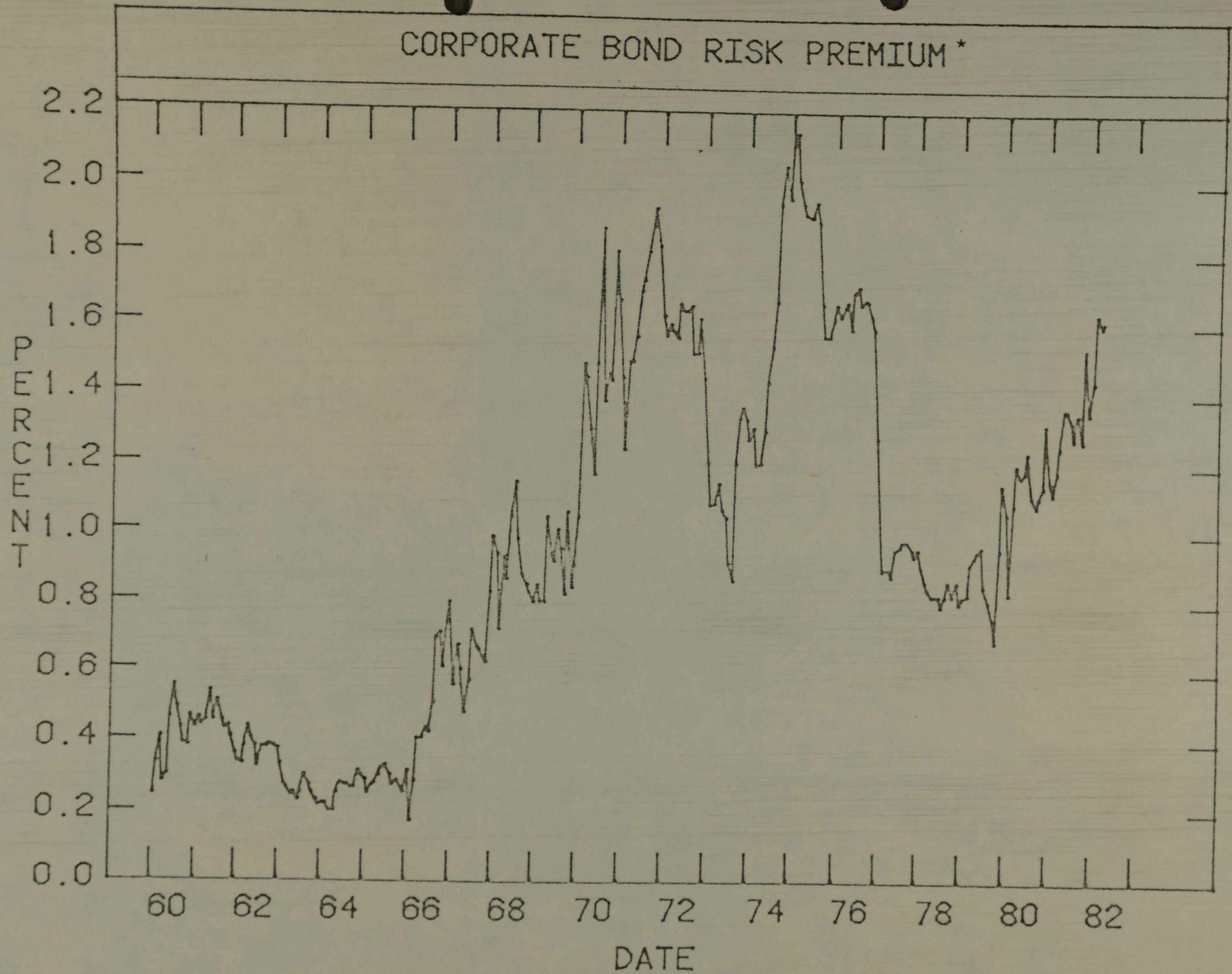
International Division
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CHART I



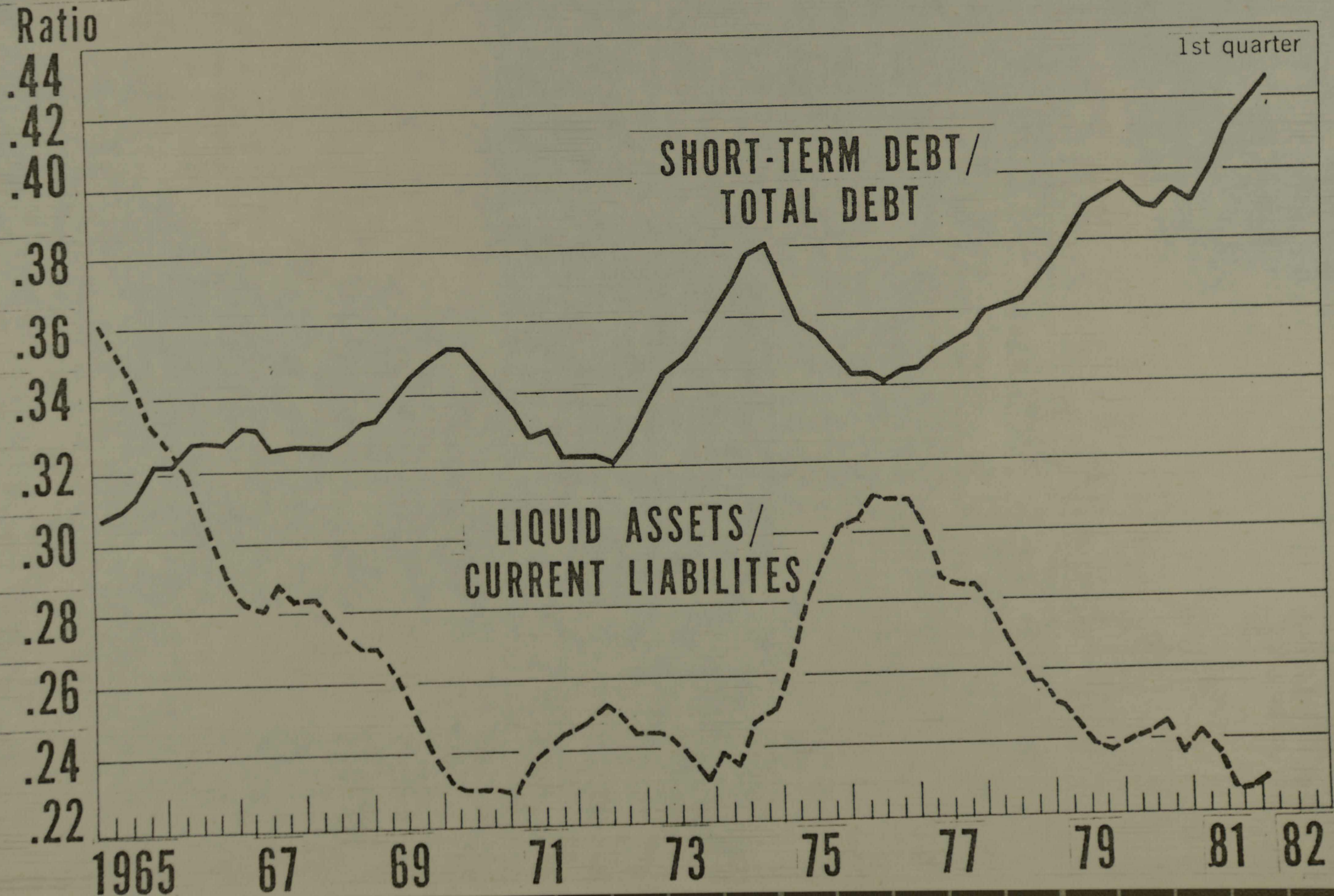
* For nonfinancial corporations. Interest is net interest (interest paid less interest received).



* Aaa seasoned corporate bond rate minus the average rate on all U.S. Treasury coupon securities with maturity ten years or more.

SELECTED LIQUIDITY MEASURES OF NONFINANCIAL CORPORATE BUSINESS

17

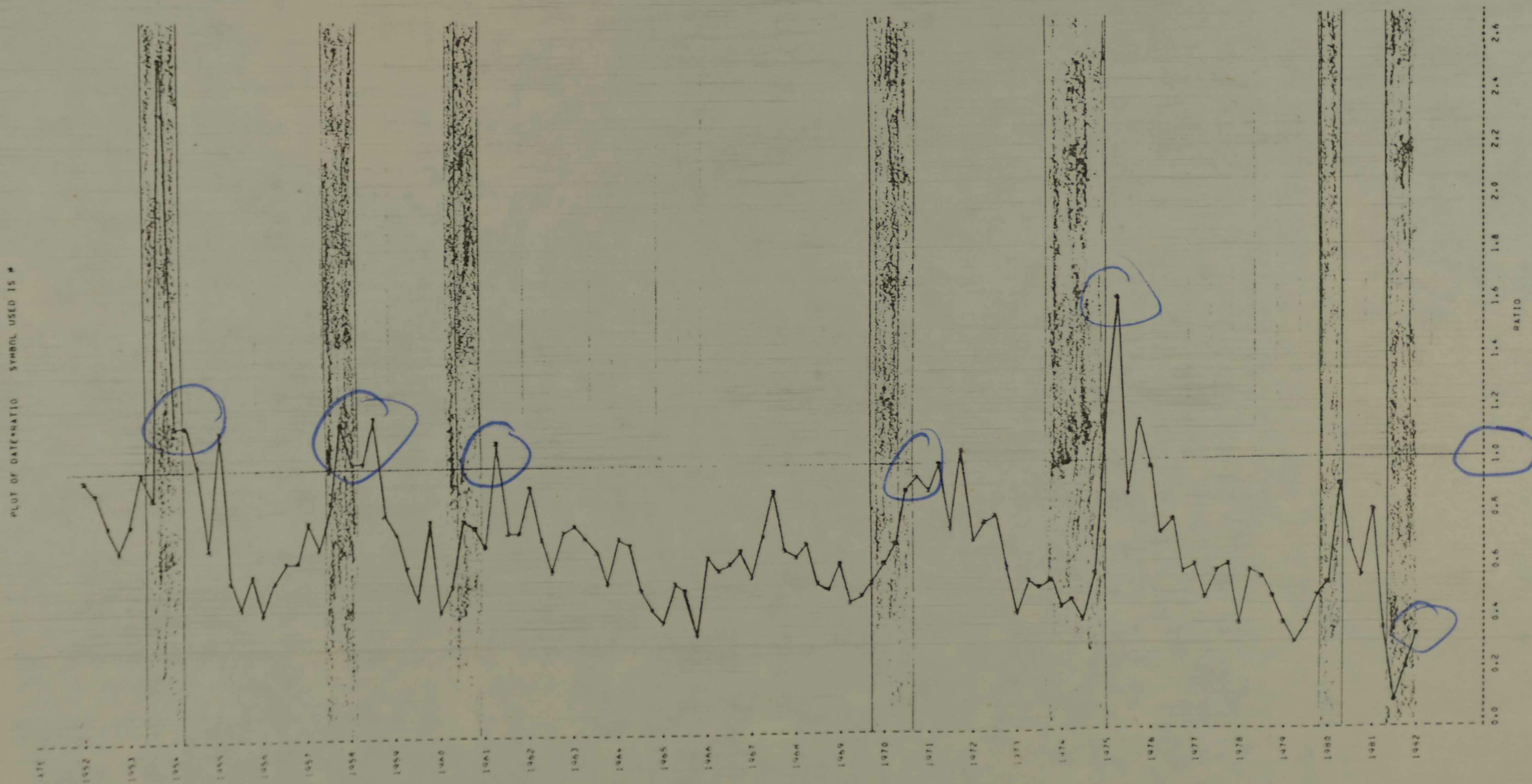


Ratio of Funds Raised by Issuing Equities, Bonds and Mortgages to Total Funds Raised in the Financial Markets

Nonfinancial Corporate Sector

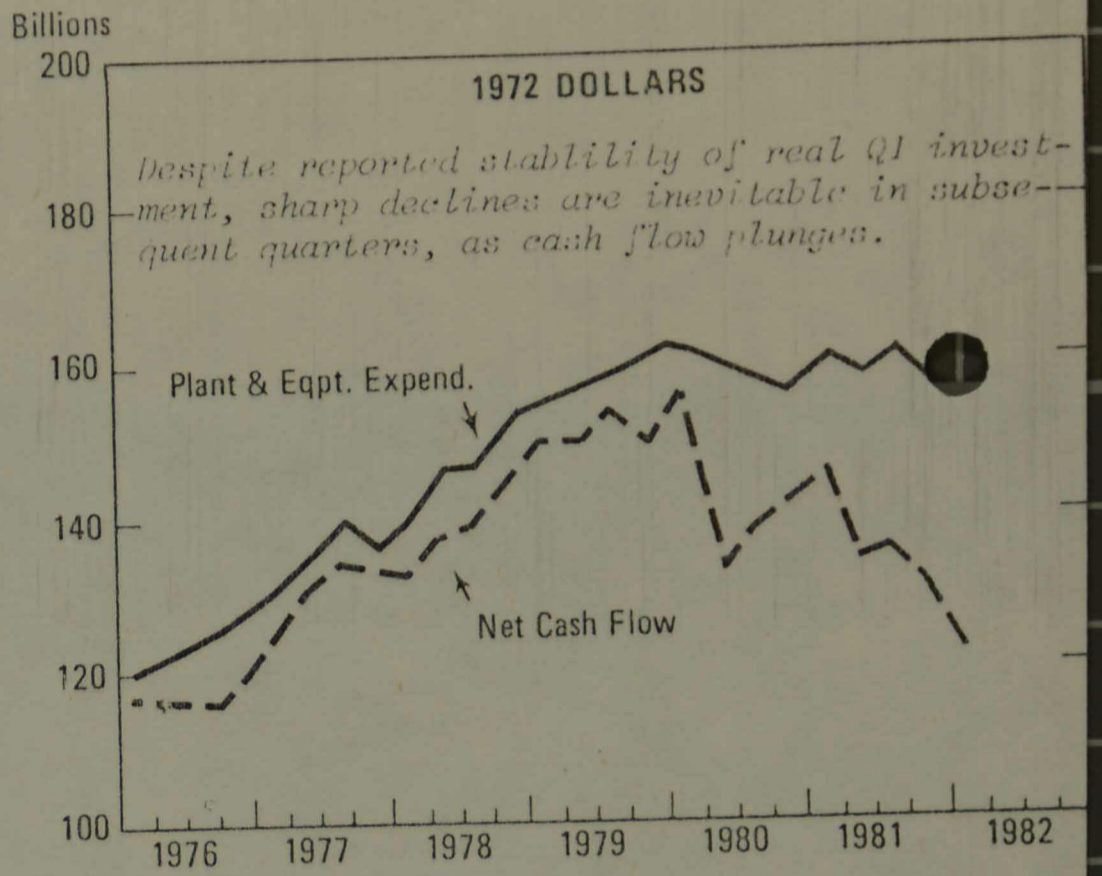
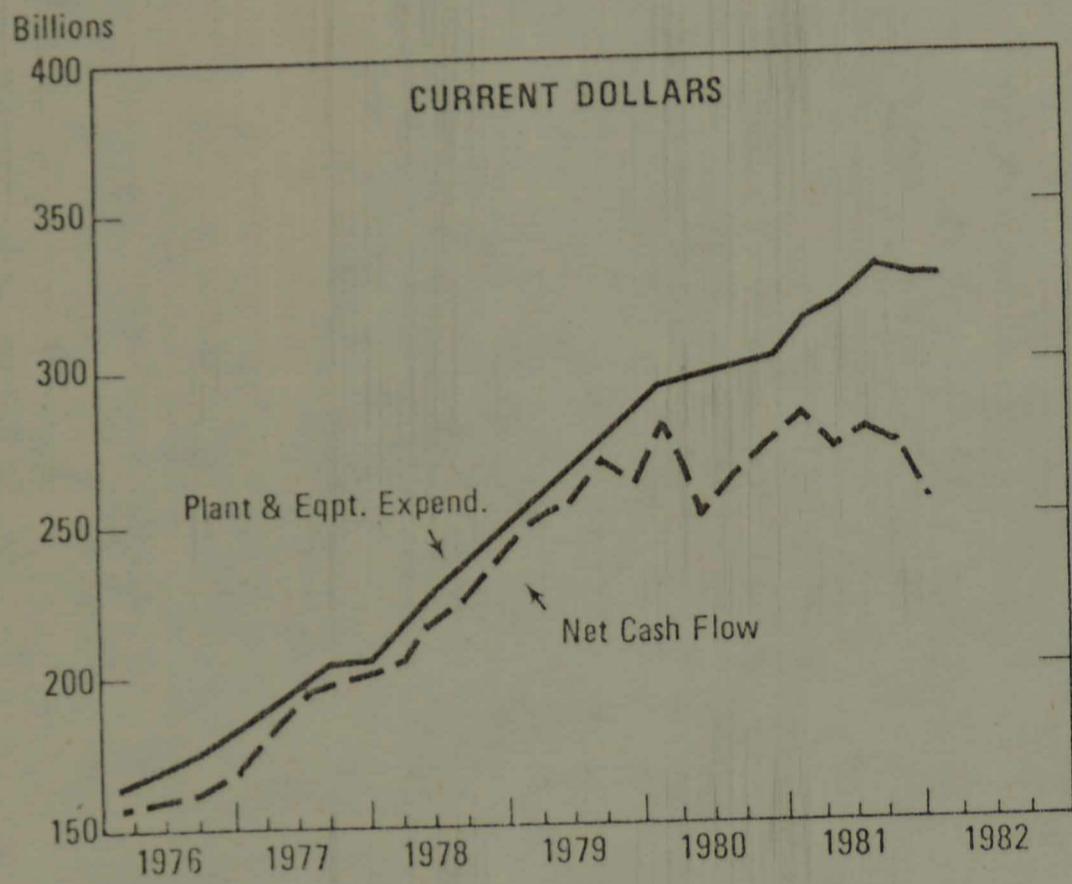
Data Seasonally Adjusted

Corporate Funding in post-war recessions



Source: Flow of Funds Section, Board of Governors, Federal Reserve System
Shaded areas are recession periods. Data from 1952 to 1982.

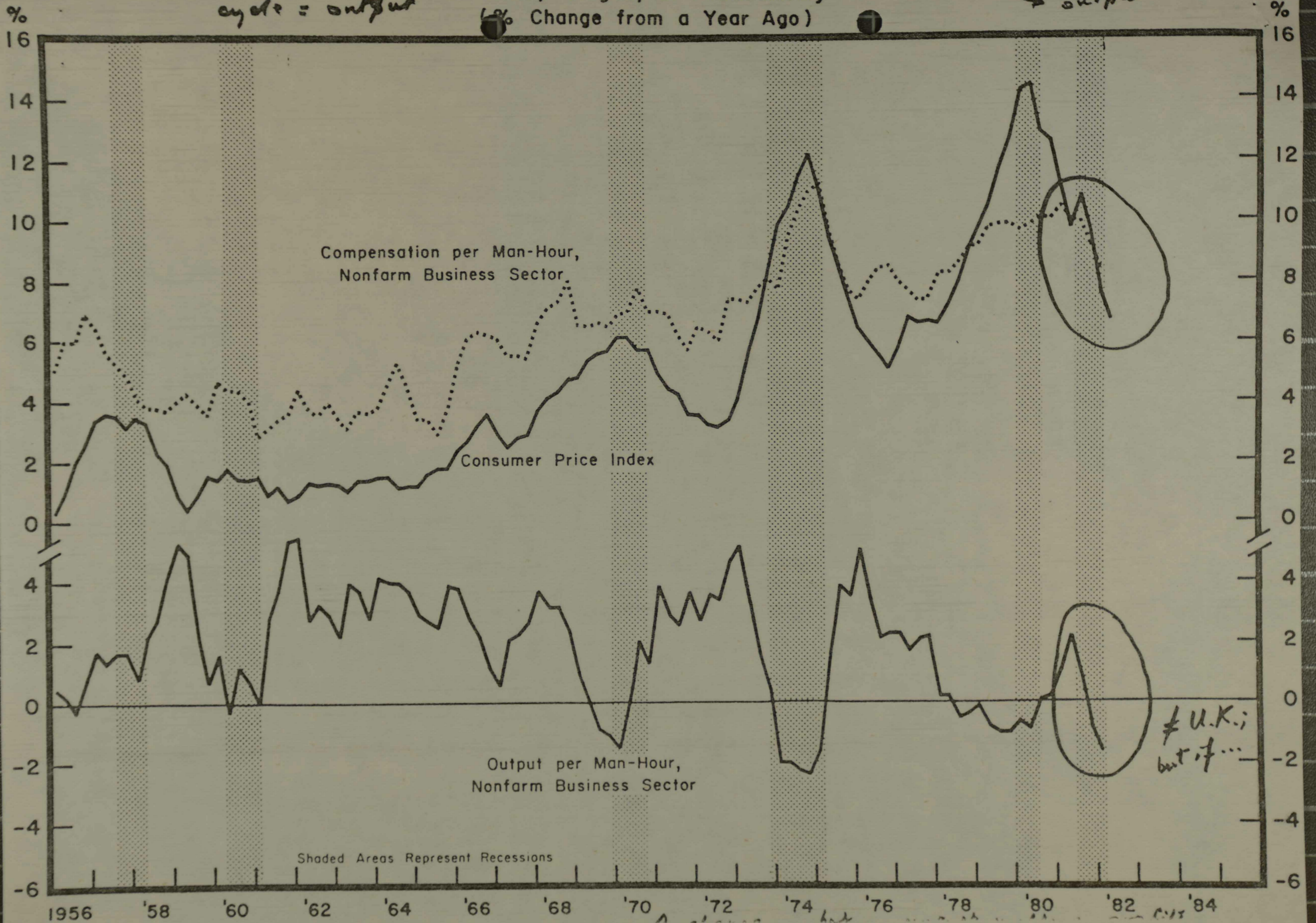
TOTAL BUSINESS CAPITAL SPENDING VS. CORPORATE NET CASH FLOW
(Seasonally Adjusted Annual Rates)



*Trend = wages
cycle = output*

Prices, Wages, & Productivity (% Change from a Year Ago)

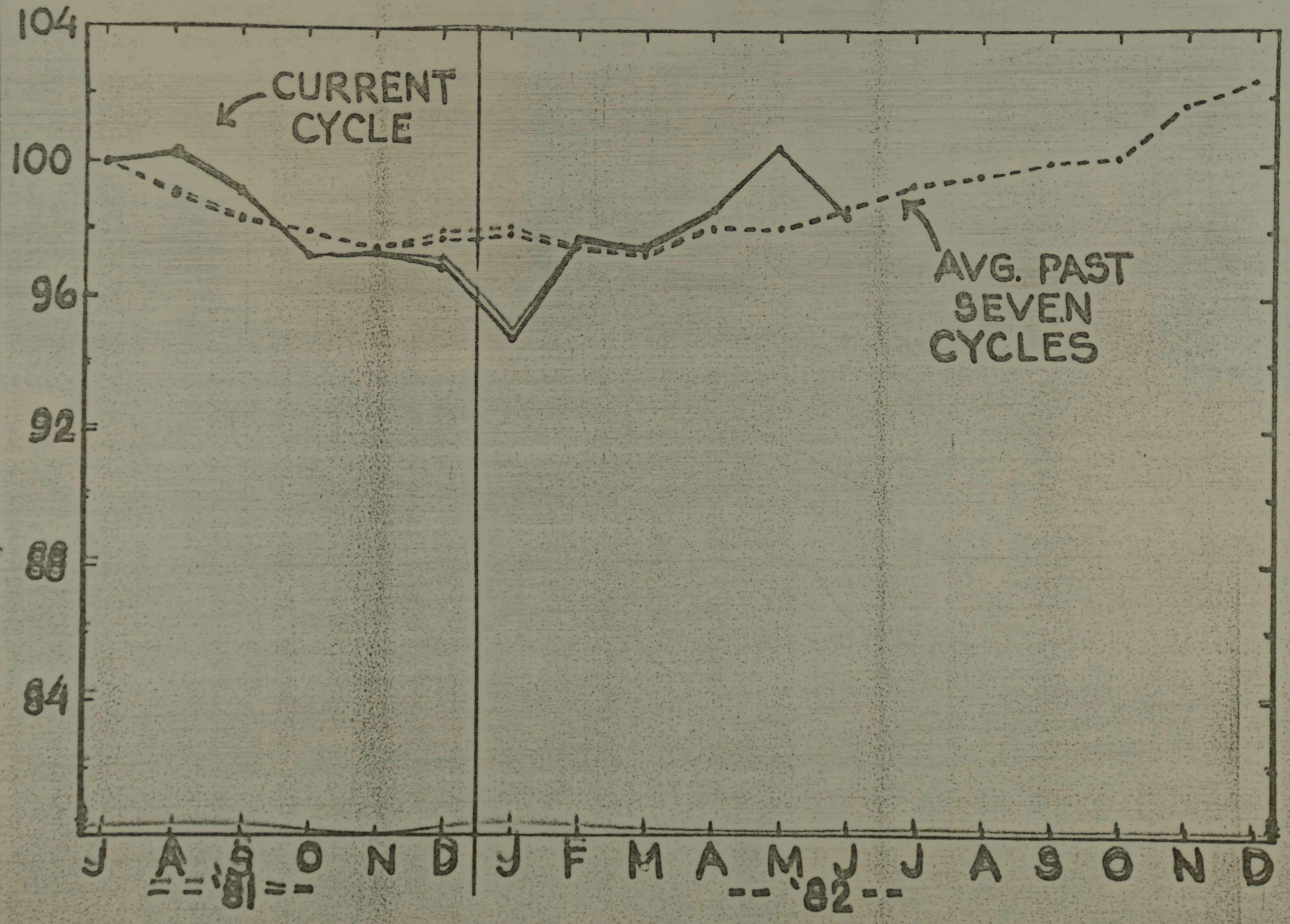
*compensation
output*



Shaded Areas Represent Recessions

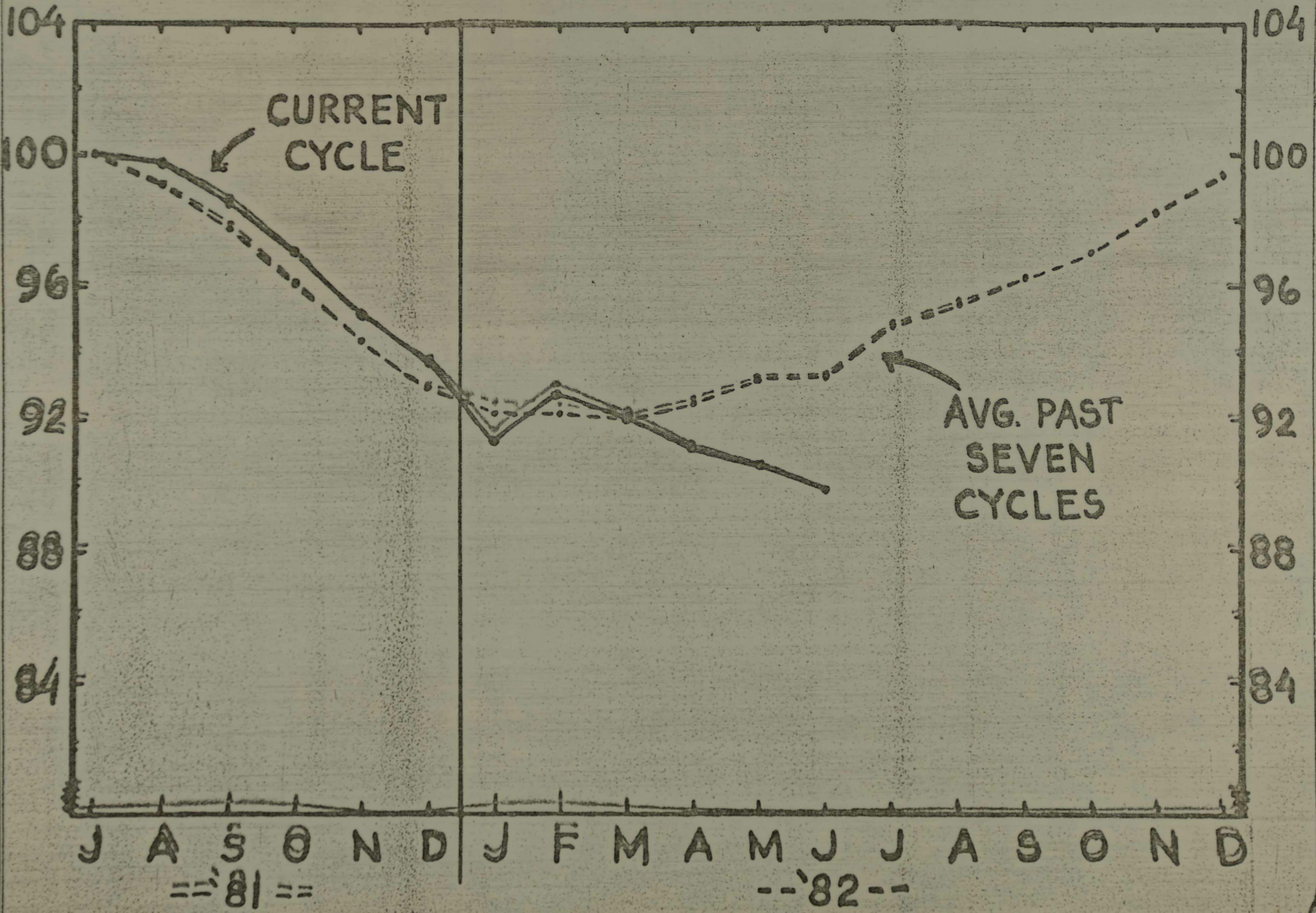
*≠ U.K.;
but if...*

"REAL" RETAIL SALES



30 81
8196

INDUSTRIAL PRODUCTION

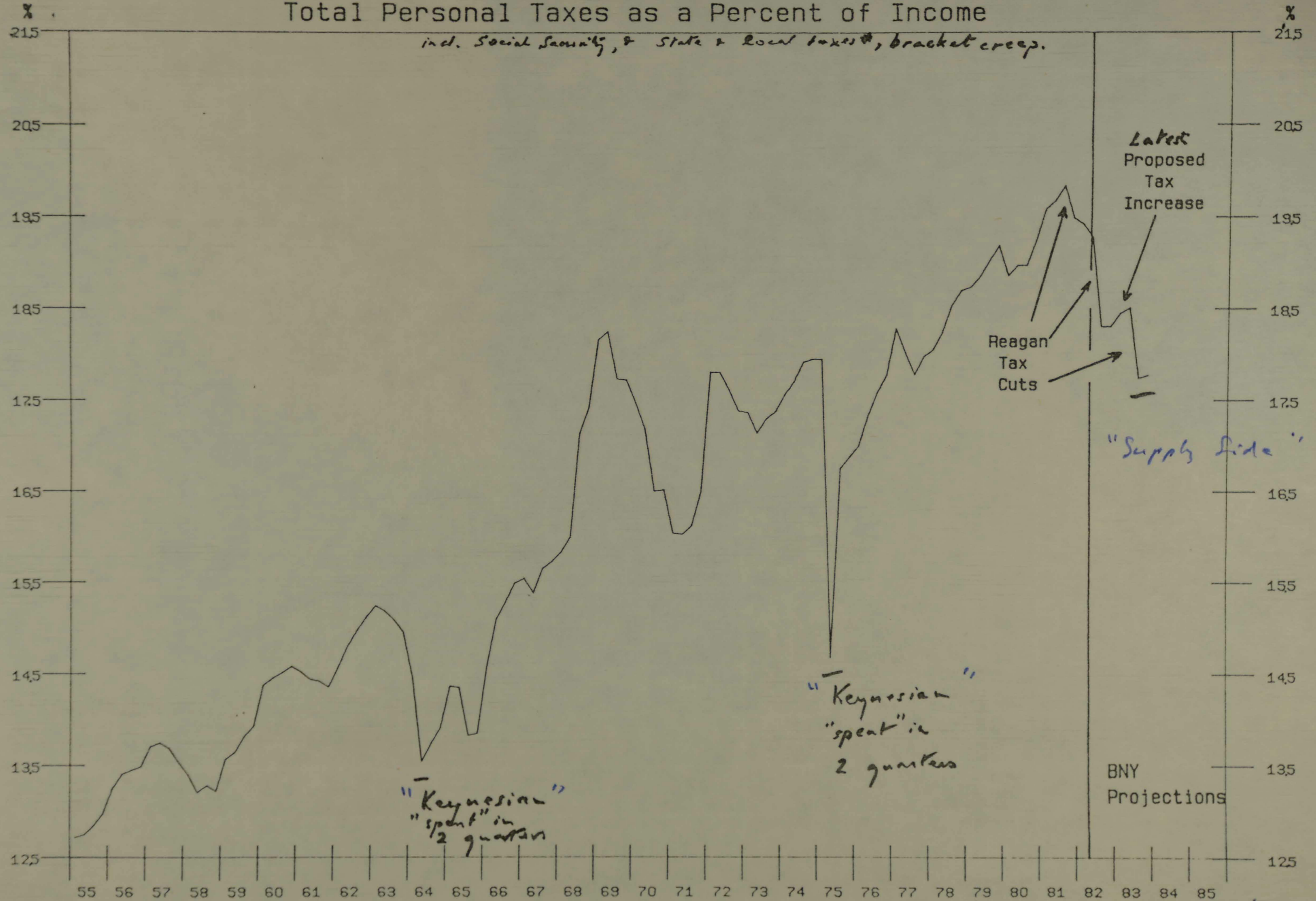


WENT CL
CAR SALES
FROM TOOL
MORE SALES!

CHART 4

Total Personal Taxes as a Percent of Income

incl. Social Security, & State & Local taxes, bracket creep.*



*"Keynesian"
"spent" in
1/2 quarter*

*"Keynesian"
"spent" in
2 quarters*

Reagan
Tax
Cuts

Latest
Proposed
Tax
Increase

"Supply Side"

BNY
Projections

* Hazardous: small adj for cuts in Federal Taxes.