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by

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It is a pleasure to join you today and to have this opportunity to share my views on recent economic developments and the near-term outlook. As you know, the Federal Reserve submitted its semi-annual report on monetary policy to Congress last week. That report, along with Chairman Volcker's testimony, discussed the decisions made by the Federal Open Market Committee regarding money and credit targets for 1987. In my remarks today, I would like to highlight some of the major themes of the report and focus on some of the risks and issues that we must be aware of in the months ahead.

In setting monetary policy targets for 1987, most of the Governors and Federal Reserve Bank presidents anticipated that real economic activity will grow about 2-1/2 to 3 percent. This would constitute a fifth consecutive year of expansion -- a performance that is distinctly better than average in business cycle annals. Although the rise in activity since mid-1984 has been slower than most of us would have hoped, it has been sufficient to create more than 7 million jobs over that time period and we expect that employment opportunities will continue to grow. The unemployment rate is now 6.7 percent, 4 percentage points below its peak in 1982; we anticipate that during 1987 the jobless rate will continue to decline.

Underlying our expectations for sustained growth were a few key assumptions. Perhaps foremost among these was that the depreciation of the dollar we've experienced over the past two years has brought about an improvement in the competitiveness of American firms sufficient to reverse the deterioration in our trade position. Admittedly, the figures to date have not signaled this clearly, but we can see the hints in the rise in export volume and in more numerous stories of improving orders from abroad, which should translate into increased export shipments in coming months. A significant improvement in our trade balance not only will help to sustain the overall growth of employment and income, but will help revive some of the sectors that have lagged in the expansion to date.

A second key assumption is that consumption will continue to perform reasonably well. We recognize that households have built up record debts in the past few years -- measured both absolutely and relative to income. This concerns us, as does the evidence in delinquencies, bankruptcies, and the like, which suggests that more than a few individuals are encountering difficulty in servicing those debt burdens. But we also recognize that the tremendous rise in the value of stocks and bonds and other financial assets since 1982 has greatly boosted the wealth of U.S. households as a group and that, as long as those gains hold up, it is likely that Americans will be willing and able to maintain their consumption patterns.

The third assumption is that, in an environment in which our tradeable goods industries are doing better, we can look forward to at least modest gains in business spending on inventories and fixed investment. Our manufacturing firms, especially, have been cautious in their capital spending in the past couple of years -- understandably so, in light of their declining rates of capacity utilization. They've focused on becoming "lean and mean," and in many cases they've succeeded: they should be able to generate good profits as their volume of business expands. As those sales and profits materialize I would expect that they would begin looking farther ahead, and making the investments in new facilities and technology that will be necessary to remain competitive in coming years. To be sure, some elements of capital spending are unlikely to show real strength in the near term. Commercial construction, for example, is likely to remain sluggish in coming months given the astonishing vacancy rates in some locales. But we are generally looking for some increases in equipment spending and industrial structures over the course of this year.

For me, and for my colleagues, one of the most positive aspects of the economic environment -- and I might say one of the most satisfying, given the efforts the Federal Reserve has made -- is the progress made in recent years toward overall price stability. Last year the increase in consumer prices was only 1-1/2 percent -- the smallest rise in two decades. Producer prices actually declined in 1986.

We are aware that last year's fine performance of the major price indexes resulted, in part, from the sharp drop in oil prices at the beginning of the year. Also, prices declined over much of the year for many other industrial and agricultural commodities that apparently were in excess supply worldwide. Because of the transitory nature of some of these developments, we do not expect quite as favorable price reports this year.

In recent months, oil prices have retraced a portion of their earlier declines and, therefore, will provide temporary upward pressure on price indexes. However, excluding oil, we expect the inflation rate to perform at least as well as last year.

I think the weight of evidence is now clear: we have established the foundation for future price stability. In 1986, nominal wage and salary increases continued to moderate over a wide spectrum of industries and occupations. Moreover, it is increasingly common for wage agreements to include more flexible compensation arrangements that will allow implementation of cost-saving measures. As a result, except for the initial stage of the current expansion, the rise in unit labor costs last year averaged less than at any time in the past twenty years. It is developments like this that will improve our ability to compete on an international basis and we should continue to work toward consolidating these gains.

I, of course, would be remiss if I did not say something about monetary policy. Simply stated, our policy last year was guided, in large measure, by the need to sustain non-inflationary economic growth in an environment of outsized trade and budget deficits. Experience dictated that monetary growth alone, particularly of the narrow aggregate M1, could not guide policy. The velocity of money -- that is, its relationship to GNP -- has been erratic and unpredictable. The velocity of M1 dropped 9-1/2 percent last year, following a decline of 5 percent in 1985. Remarkably, since 1981, the velocity of M1 has fallen 16 percent; in contrast, the trend over the previous two decades had been for velocity to rise about 3 percent per year.

The absence of inflationary pressures enabled the Federal Reserve to accommodate growth in demand for money and credit. This allowed market interest rates to drop further in 1986 and the discount rate was lowered in four steps from 7-1/2 percent at the beginning of the year to 5-1/2 percent by August. In contrast to the usual cyclical pattern, interest rates are lower today than when the expansion started over four years ago.

For 1987 the Committee retained the slightly lower targets for money growth that were announced last July for the broader aggregates. This is in keeping with our goal of attaining price stability and should be adequate to support the continued economic expansion that we anticipate. No range was specified for M1, as the Committee was wary of depending on an aggregate that has displayed so little stability in its relationship to income.

In setting our policy for 1987, the Open Market Committee could not be complacent because of the economic accomplishments of the past few years; we remained painfully aware of the many uncertainties that we face. A satisfactory economic performance this year will depend not only on the proper execution of monetary policy, but also on a disciplined fiscal policy and a determination in the private sector to improve efficiency and competitiveness.

Many of you are all too familiar with the regional and sectoral disparities in our economy. Even with the recent improvements, many manufacturing industries are still operating at low levels. Much of agriculture continues to be depressed despite massive assistance from the Federal government. And the energy industry remains hard hit. The problems in these sectors have in turn affected the financial sector, where loan losses have mounted and, in the extreme cases, institutions have failed. As you well know, such failures can have broad effects, and in your industry one of them has been the damage to the health of the Federal Savings and Loan Insurance Corporation. Although the financial condition of the thrift industry as a whole has been improving, it clearly will take time to resolve the problems that exist and, in this context, a solution to the inadequate resources of FSLIC must be found.

The situation in your industry I think serves to highlight a general point, namely that we are not going to be able to treat all of the stresses and imbalances in the economy -- and their consequences -- strictly through the application of broad fiscal or monetary policies. In particular, while I suspect that a bit of price escalation would make some real estate loans look better, I trust that this group -- having gone through the terrible experience of the late 1970s and early 1980s -- appreciates fully the fact that solutions to the problems of particular sectors or industries cannot be found by undertaking policies that produce inflation. The promotion and maintenance of price stability is a fundamental objective of monetary policy. It will be an objective in the future. By now, all of us should be convinced that attempts to employ inflation as a remedy to our economic problems ultimately will exacerbate them, not solve them.

This also needs to be emphasized with regard to our two most fundamental problems. Threats to the economic expansion presented by the deficits in our Federal budget and our trade accounts. Establishing better balance in both our external and internal accounts in a way that avoids serious dislocations is the primary problem facing the national economy.

The excessive spending habits of the Federal government combined with the severity of the 1981-82 recession have dramatically enlarged the U.S. budget deficit and saddled the economy with huge public sector borrowing needs. Fortunately, a disinflationary monetary policy and a substantial improvement in U.S. tax structure made investment in the United States relatively more attractive than other countries. And, so far, the resulting capital inflows have supplemented domestic savings enough to finance both private investment and the Federal budget deficit without putting upward pressure on interest rates.

Of course, the negative side of this surplus of capital funds into the United States is the massive current account trade deficit caused by the sharp appreciation of the dollar from 1980 to 1985 and the strong economic expansion relative to our trading partners.

The major concern today is that we are fast reaching the political limits, if not the economic limits, of a widening U.S. trade deficit.

The direct effects of the trade deficit are clear. The rising tide of import penetration in the U.S. market has yet to be reversed and our success in regaining foreign markets has been very limited to date. As a result, our manufacturing industry is left with idle capacity and factory employment suffers; the same is true in many other industries that are exposed to international competition.

Although the foreign value of the dollar dropped roughly 40 percent over the past two years aided by the Plaza Agreement and further policy coordination, the nation's real trade and current account balance continued to deteriorate due to the traditional lags in adjustment.

The Federal budget deficit also increased last year. Despite official targets and concerted efforts on the part of the Administration and the Congress, the deficit hit $221 billion. This was a record level, and in relation to GNP about matched the unprecedented postwar levels of the preceding three years.

Clearly, recent events have set the stage for progress on both of these problems. The realignment of exchange rates should slow the growth of imports and our goods are becoming more competitive abroad. But significant near-term improvement in our trade position still awaits satisfactory GNP growth in other countries. Stronger noninflationary growth from our industrial trading partners is a critical ingredient to a continuation of real growth in the United States and an improvement in economic conditions in the developing world. In the meantime, current international debt restructuring negotiations are at a difficult stage and require good faith efforts on the part of creditors. Obviously, a falling dollar alone will not solve the trade problem; and we run the risk of inflationary pressures if the depreciation of our currency should become excessive. This is why the agreement among the top industrial countries in Paris this past weekend was so important. Both West Germany and Japan announced their commitment to fiscal policy initiatives that should accelerate real income growth and allow for more stability in relative exchange rates. It is important to remember, however, that the long-term solution to our trade imbalance lies in the commitment by American industries to greater efficiency and competitiveness and a determination to resist cost increases.

While the process of reversing the trade imbalance gradually takes place, we must resist the temptation to enact "quick-fix" restrictive trade legislation. Protectionism reduces world trade and world economic activity. Today, with the greater degree of economic and financial interdependence of nations, the risks and potential losses from broad trade restrictions are larger than anytime in the past.

Our efforts must be directed toward fostering a greater openness in international trade. We must deal with legitimate complaints of unfair trading practices, and we need to seek assurances that trade can proceed on fair and reciprocal terms, while providing these same assurances to others. The benefits of a liberal system of international trade ultimately extended to all nations will lead to a strengthening of the global economy.

The process of seeking greater openness of international trade has been laborious and often frustrating. Success is rarely immediate, and, to date, the benefits seem diffuse. Nevertheless, we should not hinder progress toward our fundamental economic objectives in response to protectionist pressures. It should be understood that if the United States resorts to protective trade barriers which lead to a breakdown down in pricing discipline, the ultimate result will be higher interest rates and a tighter monetary policy.

Headway in reducing the Federal budget deficit also has been slow. But the Gramm-Rudman-Hollings targets for deficit reduction signaled the recognition by Congress that the process has begun and, more important than meeting specific numerical goals, there now seems to be a continuing commitment toward permanent spending reductions. Retreat from this effort to change the structure of the Federal budget could endanger the progress on reducing long-term interest rates because it raises questions as to whether the Federal Reserve will be able to maintain the substantial gains we have made toward achieving lasting price stability.

Moreover, regaining control of the Federal budget, so that government borrowing is less obtrusive in the capital markets, should contribute to a decline in the trade deficit since we no longer would be so dependent on foreign capital to make up the shortfall between our domestic saving and the total funds required to finance our private investment needs for plant and equipment and the remaining government borrowing.

In closing, let me say that, despite a few areas of disappointment, the economy has performed well in recent years, and I anticipate further gains in 1987. Monetary policy will accommodate these gains. But we will not lose sight of our primary objective of achieving price stability. Control over inflation has been costly. The costs are still being borne in a number of sectors. And the hazards of not facing up to our budget and trade problems now could be serious long-term damage to our standard of living. Because these risks are being increasingly understood, I am confident that progress toward fundamental resolution of these problems will be realized in 1987.