Mid-Continent Small Business United
May 30, 1985 Roma

Thank you for the invitation to meet with you this morning. As many of you know, we at the Federal Reserve Bank of Kansas City appreciate the opportunity to discuss matters of mutual interest with representatives of this region's vital small business community. We have enjoyed productive discussions for a number of years.

Many of you will recall that back in 1979 things were particulary difficult for the nation's economy and for people operating small businesses. Rapid inflation was continuing at double digit levels and interest rates were in the 20 per cent range. During this period--and into 1980, 1981 and 1982--we met regularly with representatives of Small Business United to discuss the role of Federal Reserve policy in our economy and to gain a better insight into economic developments and, the impact of economic policies on small businesses.

As many of you know, this first effort to exchange information between small business and the Federal Reserve spread to other areas of the country and other Reserve Banks. Finally, the seed planted in Kansas City through the efforts of Ron Piercy, Mike Milvain, Jim Kirk and others, led to the establishment early this year of small business advisory councils at all 12 Federal Reserve Banks. I must tell you that we are pleased that Ron Piercy has agreed to serve as one of the nine members of our council, which is made up of persons in small business and agriculture from throughout our seven-state region. The council's first formal meeting was held about a month ago.

I feel we have come a long way together. We in the Fed have confirmed our understanding of the important role of small business in the economy. And we hope many small business people better understand the Federal Reserve's objectives and the policies and tools we have available to achieve those objectives. I believe we have come to understand together that the economic objectives of business and the Federal Reserve are essentially the same.

In considering the economic objectives we share, let me turn now and focus on this morning's subject. My message includes a view that the nation's economy--despite some uneven performance--is in relatively good shape now, but that there are fundamental problems that demand the attention of policymakers. How those problems are addressed will largely determine the nation's economic future.

Let's look first at the current situation. As you know, the currnt economic expansion has continued for two and a half years. As you also know, this expansion has been outstanding in many respects. Spurred initially by a drop in the rate of inflation, and then urged on by the decline in short-term interest rates that began in 1982, economic growth was remarkably strong in 1983 and through the first half of 1984.

Even though the pace of economic growth slowed somewhat beginning in the third quarter last year--a development to be expected as the expansion matured--this particular period of U.S. business growth has been the strongest since the Korean War.

Economic expansion over this period has been aided by relatively favorable levels of interest rates. Though both nominal and real interest rates are still very high by historic standards, consumers and businesses nonetheless have been encouraged to borrow to expand their purchases of goods and services. Strong credit demand caused short-term interest rates to trend upwards through much of 1983 and 1984, but these rates dropped sharply last fall when business growth slowed. Reacting to these declines and, to an extent, facilitating them, the Federal Reserve reduced the discount rate to 8 per cent in December, and to 7 1/2 per cent just two weeks ago, the lowest level since 1978.

All in all, the past two years or so of economic growth have provided compelling evidence of our economy's breadth and power. In particular, we can take pride that more than 7 million jobs have already been created during the expansion. And we can point to many other positive developments, such as capital investment-- which is up more than 30 per cent in real terms over the period. But most of all, we are pleased that the confidence of consumers and businesses has been restored after a dismal period of economic stagnation and recession. That period which preceded the current expansion included the most devastating recession since the depression of the 1930's. So the renewed public confidence is a hard-won victory.

A major reason for the restoration of confidence in the nation's economic future is, in my judgement, the absence of excessive inflationary pressures. Now, even after a period of fairly rapid economic growth, inflation remains a relatively moderate 4 per cent or so on an annual basis. As you would expect--given the Federal Reserve's commitment to anti-inflation policies--we are gratified at the progress made so far but the battle is not yet won.

Despite the undeniable benefits to our economy of more moderate inflation and lower interest rates, a number of problems remain to be addressed before we can feel fully optimistic about the longer-term health of our economy. Many of these problems are related to adjustments required in moving from a period of rapid inflation and high inflationary expectations to a period with a more moderate inflationary outlook. As you know, many decisions made earlier in anticipation of ongoing inflation continue to plague businesses and financial institutions during the current period of disinflation. The consequences of those earlier inflation-biased decisions often are not easily managed and, taken together, complicate the search for solutions to our economic problems.

Against that background of strong business growth and moderate inflation, I would like to consider with you briefly the outlook for the nation's economy. Before giving you my impressions of the near-term prospects for continued business growth, I want to examine the potential for the nation's long-term economic health. In so doing, I want to note some problems which, in my view, remain barriers in the path of sustainable noninflationary growth that we seek. These problems, which include the nation's international trade deficit, the strains affecting our financial institutions, and the federal budget deficits, are all interrelated.

One problem is the strength of the U.S. dollar in international currency markets resulting from our relatively high interest rates and our favorable business situation. With the dollar so strong, U.S. exports have been weak as domestic producers have been priced out of world markets. Overall, the poor performance of the export sector has caused the current business expansion to be very unbalanced. Our own region, in particular, has suffered because agricultural producers have lost many export sales. Other sectors serving agriculture have been robbed of potential growth. At the same time, the flood of imported goods priced in weaker currencies has contributed to the serious imbalance in our trade position, while stealing sales from our domestic businesses.

To be sure, a strong dollar has brought our economy some temporary benefits. For example, the inflow of foreign capital has helped in the short run to finance both the business expansion and the federal budget deficit. Another benefit is that the availability of abundant foreign capital has kept our interest rates lower than they otherwise might have been. But these so-called benefits have certain side effects. Some observers have pointed out that the United States is rapidly becoming a debtor nation, an unfamiliar situation, indeed, for the richest nation in the world.

When the international value of the dollar eventually declines, which it will, the consequences of that decline will present mixed blessings, at best. On the positive side, a lower dollar would certainly improve the competitive position of U.S. goods in world markets and boost our lagging export sector. However, a falling dollar could put upward pressure on domestic interest rates--as foreign capital moves elsewhere. Moreover, a declining dollar will lead to some inflationary pressures as foreign goods become more costly and as domestic businesses lose some competitive price discipline. In any case, the strength of the dollar has been a problem and a decline in its value may well have negative consequences.

In addition to the trade deficit and strength of the dollar, a second problem is the continuing strains affecting our financial institutions. One highly visible aspect of this problem is the inability of many lesser developed countries to repay on time or even service their huge debts in the face of worldwide recession and disinflation. This situation has raised questions about the earnings and capital positions of many of the world's major banks. Fortunately, it appears that lower interest rates, restructured loan agreements, and worldwide economic growth have begun to ease some of the pressure. Nevertheless, resolution of the problem will require considerable time and its effects will add a precautionary flavor to the outlook for years to come.

Though the international debt crisis dominated many of the headlines over the last two years or so, financial institutions have been beset by domestic troubles, as well. An extended period of high interest rates--caused, in my view, by the federal budget deficits--has created continuing difficulties for many business firms, particularly in agriculture and energy. These problems, in turn, have been felt by financial institutions struggling to help finance the economic expansion. Financial deregulation has also contributed to the problems of financial institutions. Weakened thrift institutions and bank failures--79 last year and about 36 so far in 1985--are symptoms of these problems. So, too, are the troubles of Continental Illinois and, to some extent, the Ohio and Maryland thrift institutions in recent months.

A third--and the most troubling and pervasive--problem clouding the long-term economic outlook is the current and prospective federal budget deficits. I don't plan on "preaching to the choir" this morning because I know that most of you here share the conviction that continuing massive budget deficits represents a serious hazard to economic progress. Small business representatives have been quite vocal in expressing their concerns about the perils of the deficits and I know that that many of you in this room have written or visited with your elected representatives in Washington about this issue.

Many of us believe that the government's borrowing to finance the deficits will ultimately collide with the private sector's need for credit to fund continued growth. When both public and private credit demands are growing, the likelihood of rising interest rates increases, as well. Aside from their costly impact on business, rising interest rates could raise public fears about renewed inflation. And high inflationary expectations would surely weaken the foundation of growth with lower inflation which has been laid.

I do want to emphasize my belief that reducing--and eventually eliminating--budget deficits would remove a persistent thorn from the side of the nation's economic potential.

Does anyone not believe that real deficit reductions would reduce real interest rates and diminish the inflationary fears generated by such massive deficits? Such a result surely would help relax upward pressure on the dollar and permit U.S. exports to compete more effectively in world markets. If the dollar's relative value could be reduced gradually, a series of orderly adjustments in international financial and commodity markets could take place. Furthermore, if deficit reductions ease interest rate pressures, our financial institutions could anticipate further relief from the strains I described earlier.

In the final analysis, meaningful deficit-reduction action is an absolutely necessary step in resolving the problems clouding the long-term outlook. Moreover, in my judgement, such a program is essential for the ultimate economic health of the nation. Thus, we all are watching the current budget debates in Washington with considerable concern. Let us hope that the current discussions and legislative debate will, indeed, lead to a strong first step toward a real political commitment for deficit reduction.

Now let me turn to a brief discussion of the economic outlook for 1985. On this count, I continue to be generally optimistic that moderate and sustainable economic growth with relatively low inflation can be achieved this year. I say this because recent developments appear to have set the stage for such an outcome, even though some observers now are questioning the staying power of the business expansion. 15

For one thing, short-term interest rates have come down sharply over the past 10 months or so and remain well below last summer's peaks, primarily because credit demands have lessened as the economy shifted from rapid growth to a more sustainable pace. But I believe that these lower levels of interest rates also reflect optimism about inflation. Downward pressure on oil prices and continuing moderation in wages and commodity prices are helping to reinforce reduced inflationary expectations and to preserve real income gains. Given this positive tone, I believe that households and businesses will be encouraged to continue to lead the expansion.

Though economic data are showing some mixed signals, continuing strength is evident in spending for construction and other capital items, in factory orders, and in overall consumer spending, including sales of new homes and automobiles. However, the manufacturing and export sectors remain quite weak and capital spending appears to be slowing rather abruptly this year.

These developments and their effect on the outlook are still generally in line with economic projections made in February by members of the Federal Open Market Committee. My colleagues and I collectively expected real GNP growth this year in the 3 to 4 per cent range, with prices rising perhaps 3 1/2 to 4 per cent. We also expect unemployment in the fourth quarter of 1985 to average about 6 1/2 to 7 percent.

As always, a key factor in the economic outlook for 1985 is the role that monetary policy will play. As most would agree, monetary policy has earned considerable credibility in the financial markets and among the American public because of the Federal Reserve's consistent adherence to a firm anti-inflationary policy. This policy is generally credited for much of the success to date in bringing inflation under better control. Thus, it will not surprise you much when I say that, for 1985, the Federal Reserve remains committed to providing money and credit to the economy at a pace which will support sustainable business expansion while, at the same time, maintaining progress toward price stability. I should point out that the tentative growth rate ranges for the monetary aggregates announced in February again reaffirm our stated intention to reduce, over time, the growth of money and credit.

With continued moderate economic growth and typical demand for money and credit, we would expect interest rates to remain relatively stable over the upcoming period. Many financial market observers believe that the Federal Reserve's recent discount rate action will complement a general move to lower short-term rates in coming weeks. What the Federal Reserve seeks over the long run, of course, is for interest rates to come down and stay down so that greater investment and continued growth will be encouraged. In the short run, however, given the Federal Reserve's commitment to a policy of moderate growth in money and credit, and given no resolution of the deficit issue, a return to very rapid economic growth would again undoubtedly put upward pressure on interest rates.

In summary, the economy has grown steadily over the past two and a half years, and it should continue to expand through 1985. The pace of expansion this year will be somewhat more moderate than the earlier rapid growth, but that is to be expected in a maturing expansion. Over the longer term, however, the ultimate health of the economy depends on meaningful reductions in the huge federal budget deficits. Such reductions would help importantly to bring about orderly domestic and international adjustments to the new environment of disinflation. I am convinced that if our elected officials will seriously address this issue we can look forward to continued progress for the nation's economy throughout much of the 1980's.

Thank you for your invitation and kind attention.