



FEDERAL RESERVE BANK OF SAN FRANCISCO
Office of the President

Inflation and Government Policy

**Remarks of
John J. Balles, President
Federal Reserve Bank of San Francisco**

**Meeting with San Francisco Community Leaders
and Reserve Bank Directors,
Federal Reserve Bank of San Francisco**

San Francisco, California

August 3, 1981

INFLATION AND GOVERNMENT POLICY

FIRST THE GOOD NEWS -- THE ALL STAR GAME WILL BE PLAYED THIS YEAR AFTER ALL. AND THE BAD NEWS OF COURSE IS THAT THE PLAYERS MAY NOT BE ABLE TO REACH THE BALLPARK BECAUSE OF THE AIR CONTROLLERS' STRIKE. CLOSER TO HOME, THE STRIKE (AND A THREATENED FILIBUSTER) MAKE IT IMPOSSIBLE FOR US TO HEAR SENATOR GARN PERSONALLY TODAY. BUT SINCE YOU'RE GETTING ONLY A BRIEF VIDEOTAPE VIEW FROM CAPITOL HILL, PERHAPS YOU'LL BE INTERESTED IN A SUPPLEMENTARY VIEW FROM ANOTHER MAJOR POWER CENTER -- LOCATED ON CONSTITUTION AVENUE IN WASHINGTON AND LOCATED HERE IN OUR FORTRESS ON SANSOME STREET.

FISCAL POLICY ROLE

LET'S CONSIDER THE STEPS THAT POLICYMAKERS ARE NOW TAKING TO SOLVE THE NATION'S PROBLEMS OF HIGH INFLATION, HIGH INTEREST RATES, AND WEAKNESS OF MAJOR INDUSTRIES. IN THIS CONNECTION, THE PRESIDENT'S MASTERY OF THE POLITICAL PROCESS GIVES US HOPE THAT FISCAL POLICY WILL PLAY A STRONGER ROLE IN GETTING THE ECONOMY BACK ON A NONINFLATIONARY GROWTH PATH. IN HIS VIEW, MANY OF THE NATION'S WOES STEM FROM EXCESSIVE TAX RATES THAT RETARD PRODUCTIVITY AND GROWTH, AND SO LAST WEEK HE PUSHED THROUGH SUBSTANTIAL CUTS IN INCOME AND OTHER TAXES TO SOLVE THAT PROBLEM. BUT HE PRECEDED THAT MOVE, MORE THAN A MONTH AGO, BY STEPS TO REVERSE THE TREND OF FEDERAL SPENDING, IN AN ATTEMPT TO CURB THE INFLATIONARY POTENTIAL OF CONTINUED MASSIVE FEDERAL DEFICITS.

THE TAX MEASURES PASSED BY CONGRESS LAST WEEK ARE DESIGNED TO CUT TAXES BY NEARLY \$38 BILLION IN FISCAL 1982 AND BY PERHAPS \$200 BILLION BY 1985. THE CENTERPIECE OF THIS PROGRAM OF COURSE IS THE 25-PERCENT ACROSS-THE-BOARD CUT IN INDIVIDUAL INCOME-TAX RATES, BEGINNING WITH THE 5-PERCENT CUT THIS OCTOBER 1 AND FOLLOWED BY THE 10-PERCENT REDUCTIONS OF JULY 1982 AND JULY 1983. BUT THE BILL HAS MANY OTHER IMPORTANT FEATURES -- MOST IMPORTANTLY, FASTER DEPRECIATION WRITE-OFFS FOR BUSINESS FIRMS. AT LONG LAST, CONGRESS HAS REPLACED THE OLD JUMBLE OF DEPRECIATION SCHEDULES WITH FOUR BASIC CATEGORIES -- A 3-5-10-15 SCHEDULE WHICH, ESSENTIALLY, PROVIDES FOR VEHICLES TO BE WRITTEN OFF IN THREE YEARS, EQUIPMENT IN FIVE YEARS, AND LONGER-LIVED PROPERTY IN TEN TO FIFTEEN YEARS.

THE EARLIER DECISION TO MATCH TAX CUTS WITH SPENDING CUTS WAS EQUALLY IMPORTANT -- INDEED PERHAPS MORE IMPORTANT IN THE LONG RUN, BECAUSE IT REVERSED A 50-YEAR TREND IN THE GROWTH OF THE FEDERAL GOVERNMENT. ABOUT \$730 BILLION WOULD HAVE BEEN SPENT IN THE 1982 FISCAL YEAR IF CURRENT PROGRAMS HAD CONTINUED UNCHANGED. BUT THAT FIGURE WAS REDUCED TO \$695 BILLION BY THE BROAD-SCALE CUTBACKS MADE IN A HOST OF FEDERAL PROGRAMS IN THE BUDGET-RECONCILIATION PROCESS AT MIDYEAR. BY THAT PROCESS, THE ADMINISTRATION AND THE CONGRESS ADDED REAL MEANING TO THE TERM "CONTROL" IN THE BUDGET CONTROL ACT OF 1974.

THE ADMINISTRATION, IN ITS MIDYEAR BUDGET REVIEW, ESTIMATED THAT THE RESULTANT OF THESE TAX AND EXPENDITURE DECISIONS WOULD BE A \$56-BILLION DEFICIT IN THE FISCAL YEAR ENDING NEXT MONTH, AND A \$43-BILLION DEFICIT IN THE 1982 FISCAL YEAR. LAST-MINUTE

CHANGES IN LAST WEEK'S TAX BILL COULD PUSH THE 1982 DEFICIT HIGHER, PERHAPS TO ABOUT \$50 BILLION. MOREOVER, WE SHOULD REMEMBER THAT ACTUAL SPENDING TOTALS HAVE FAR OUTPACED INITIAL SPENDING ESTIMATES IN MOST RECENT YEARS, PERHAPS BY A MARGIN OF \$45 BILLION THIS YEAR. THOSE FIGURES ONLY ADD MORE URGENCY TO THE FUTURE NEED TO KEEP SPENDING UNDER CONTROL, ESPECIALLY IN VIEW OF THE FACT THAT REVENUES WILL BE HELD DOWN IN THE MID-1980'S BY THE INFLATION INDEXING OF INCOME-TAX BRACKETS.

MONETARY POLICY ROLE

NOW THE FEDERAL RESERVE, THROUGH ITS MONETARY POLICY, HAS A PARALLEL TASK TO PERFORM BY KEEPING MONEY-SUPPLY GROWTH IN LINE WITH A NONINFLATIONARY GROWTH PATH FOR THE NATIONAL ECONOMY. BUT THERE'S A GREAT DEAL OF MISUNDERSTANDING ABOUT ITS ROLE, WHICH IS FREQUENTLY DISMISSED AS SIMPLY A "HIGH INTEREST RATE" POLICY. SO LET'S PAUSE TO REVIEW SOME OF THE CONFLICTING VIEWS ABOUT MONETARY POLICY, ESPECIALLY SINCE THEY OFTEN LEAD TO CONFLICTING POLICY ADVICE. TO THE AVERAGE NEWSPAPER READER OR LEGISLATOR, EASY MONEY MEANS LOW INTEREST RATES, AND TIGHT MONEY MEANS HIGH INTEREST RATES. TO THE AVERAGE ECONOMICS PROFESSOR OR FINANCIAL ANALYST, EASY MONEY MEANS RAPID MONEY GROWTH, AND TIGHT MONEY MEANS SLOW MONEY GROWTH. AT TIMES OVER THE PAST TWO YEARS, WE'VE FOUND OURSELVES CRITICIZED BY ONE SIDE AS BEING TOO EASY, AND BY THE OTHER SIDE FOR BEING TOO TIGHT.

SO HOW SHOULD WE RESPOND? TO THE INTEREST-RATE WATCHERS, WE WOULD SUGGEST THAT INTEREST RATES ARE DETERMINED BY MANY FACTORS -- INCLUDING BUT NOT EXCLUSIVELY THE ACTIONS OF THE

FEDERAL RESERVE, WHICH CAN CONTROL ONLY THE SUPPLY OF MONEY, NOT THE DEMAND. CERTAINLY THE FED HAS SOME EFFECT ON RATES IN THE SHORT RUN, AS IT WORKS TO CONTROL THE AMOUNT OF RESERVES IN THE BANKING SYSTEM AND MONEY IN THE HANDS OF THE PUBLIC.

HOWEVER, BUSINESS-CYCLE CONDITIONS ALSO INFLUENCE RATES, AS CREDIT DEMANDS RISE AND FALL WITH THE CYCLE. AND ABOVE ALL, PRICE EXPECTATIONS HEAVILY INFLUENCE RATES, FREQUENTLY OFF-SETTING OTHER MARKET INFLUENCES. TODAY, FOR EXAMPLE, IF PEOPLE EXPECT PRICES TO RISE BY (SAY) 10 PERCENT A YEAR, LENDERS WILL DEMAND THAT 10-PERCENT INFLATION PREMIUM PLUS THE "REAL" UNDERLYING RATE OF INTEREST OF 3 OR 4 PERCENT, SO THAT THEY'LL BE PROTECTED AGAINST AN EXPECTED LOSS IN THE PURCHASING POWER OF THEIR MONEY. THIS SUGGESTS, THEN, THAT CURBING INFLATION IS THE ONLY LONG-RUN SOLUTION TO HIGH INTEREST RATES.

TO THE MONEY-SUPPLY WATCHERS, WE WOULD SAY THAT MONETARY POLICY IN RECENT YEARS HAS BEEN DIRECTED TOWARD REDUCING MONEY GROWTH -- ESPECIALLY SINCE WE SHIFTED OUR OPERATING PROCEDURES NEARLY TWO YEARS AGO TO EMPHASIZE MONEY-GROWTH CONTROL RATHER THAN INTEREST-RATE CONTROL. OUR EXPERIENCE HAS CLEARLY DEMONSTRATED THAT DURING PERIODS OF HEAVY PRIVATE PLUS GOVERNMENT CREDIT DEMANDS, ATTEMPTS TO DAMPEN RISING INTEREST RATES RESULT IN RAPID MONEY GROWTH. AND HISTORY ALSO HAS SHOWN THAT RAPID MONEY GROWTH EVENTUALLY LEADS TO INFLATION, ACCOMPANIED BY HIGH INTEREST RATES. THIS SUGGESTS, THEN, THAT THE FED SHOULD CONTINUE TO FOLLOW THE PATH OF GRADUAL DECELERATION ADOPTED IN OCTOBER 1979.

STILL, WE HAVE TO RECOGNIZE THAT THE FED'S SHIFT IN EMPHASIS AWAY FROM TRYING TO CONTROL INTEREST RATES CAN INVOLVE SHORT-TERM COSTS. HOME BUILDERS, FARMERS, SMALL BUSINESSES, AND OTHER INTEREST-SENSITIVE BORROWERS CAN BE BADLY HURT BY HIGH AND FLUCTUATING LEVELS OF INTEREST RATES. THE FED THUS MUST STEP IN AT TIMES TO DAMPEN EXCESSIVE RATE SWINGS, EVEN AT THE COST OF TEMPORARY DEVIATIONS IN THE GROWTH PATH OF THE MONEY SUPPLY.

ON BALANCE, THE FEDERAL RESERVE HAS NO CHOICE EXCEPT TO CONTINUE WITH ITS POLICY OF REDUCING MONEY-SUPPLY GROWTH OVER TIME, TO HELP THE NATIONAL ECONOMY RETURN TO A NON-INFLATIONARY GROWTH PATH. I MIGHT ADD THAT THE ADMINISTRATION HAS STRONGLY ENCOURAGED THE FED IN THIS POLICY OF MONETARY DISCIPLINE. THE M1-B MEASURE OF THE MONEY SUPPLY -- CURRENCY PLUS TRANSACTION (CHECK-TYPE) ACCOUNTS -- DECELERATED SLIGHTLY IN EACH OF THE PAST TWO YEARS, AND NOW IS NEAR OR EVEN BELOW THE BOTTOM OF ITS TARGET RANGE FOR 1981. THAT GROWTH RANGE IS $3\frac{1}{2}$ TO 6 PERCENT, AFTER ADJUSTMENT FOR SHIFTS OF SAVINGS INTO CHECK-LIKE NOW ACCOUNTS. BUT THE M-2 MEASURE -- PRIMARILY CURRENCY PLUS ALL DEPOSITORY-INSTITUTION DEPOSITS (EXCEPT LARGE CDs) AND MONEY-MARKET FUND SHARES -- HAS BEEN RUNNING NEAR THE TOP OF ITS 6-TO-9 PERCENT TARGET RANGE THIS YEAR, ALTHOUGH BELOW LAST YEAR'S ACTUAL GROWTH. THE DIFFERENCE IN GROWTH TRENDS CAN BE TRACED ULTIMATELY TO THE IMPACT OF HIGH INTEREST RATES ON HOUSEHOLD AND BUSINESS CASH-MANAGEMENT PRACTICES, MINIMIZING THEIR USE OF TRADITIONAL TRANSACTION BALANCES AND STIMULATING

THE GROWTH OF MONEY-MARKET MUTUAL FUNDS AND OTHER COMPONENTS OF THE BROADER MONETARY AGGREGATES.

FOR THE REMAINDER OF 1981, ACCORDING TO CHAIRMAN VOLCKER'S RECENT CONGRESSIONAL TESTIMONY, THE FEDERAL RESERVE BELIEVES THAT IT WOULD BE ACCEPTABLE TO HOLD M-1B GROWTH NEAR THE BOTTOM OF ITS RANGE, AND TO HOLD M-2 GROWTH NEAR THE TOP OF ITS RANGE. AND FOR 1982, THE FED TENTATIVELY HAS AGAIN REDUCED ITS PROJECTED GROWTH RANGE FOR M-1B, TO BETWEEN $2\frac{1}{2}$ AND $5\frac{1}{2}$ PERCENT, WHILE MAINTAINING A 6-TO-9 PERCENT RANGE FOR M-2. THUS, BY CARRYING OUT OUR "GAME PLAN" OF REDUCED MONEY GROWTH IN 1981, AND PROJECTING SIMILAR DISCIPLINE NEXT YEAR, WE SHOULD ADD CREDIBILITY TO THE NATION'S ANTI-INFLATION PROGRAM, AND HELP TO REVERSE LONG-STANDING EXPECTATIONS OF CONTINUED HIGH INFLATION.

IMPLICATIONS FOR PRODUCTION

THE COMBINATION OF MONETARY AND FISCAL MEASURES THAT I'VE OUTLINED SHOULD LEAD, WITHIN SEVERAL YEARS' TIME, TO A PERIOD OF GROWTH WITH PRICE STABILITY. BUT THE NEAR-TERM OUTLOOK, FOR THE MOST PART, HAS ALREADY BEEN DETERMINED BY EARLIER DEVELOPMENTS -- PRINCIPALLY BY THE SEVERE INFLATION OF THE PAST DECADE AND BY THE RECENT POLICY MEASURES TAKEN TO BRING THAT INFLATION UNDER CONTROL. THUS THE CONSENSUS FORECAST, WHICH IS SHARED BY MY RESEARCH STAFF, CALLS FOR A FAIRLY FLAT LEVEL OF BUSINESS ACTIVITY UNTIL ABOUT THE MIDDLE OF NEXT YEAR, FOLLOWED BY A SIGNIFICANT UPTURN IN LATE 1982.

AS ALWAYS, MUCH DEPENDS UPON CONSUMER BUYING DECISIONS, SINCE HOUSEHOLD SPENDING ACCOUNTS FOR ALMOST TWO-THIRDS OF GNP.

(INDEED, FOR THREE YEARS IN A ROW, 1979-81, BUSINESS ACTIVITY DROPPED SHARPLY IN THE SECOND QUARTER BECAUSE OF A FALL-OFF IN CONSUMER SPENDING.) IN SUMMER 1981, CONSUMERS ARE CONTINUING TO BUY CAUTIOUSLY, BECAUSE OF A SLOWDOWN IN REAL INCOME, RESTRICTIVE CREDIT CONDITIONS, AND A MIXED EMPLOYMENT OUTLOOK. THE NEW TAX CUTS SHOULD EVENTUALLY BOOST CONSUMER SPENDING -- AND SAVING TOO, I HOPE -- BUT MOST OF THAT IMPACT MAY NOT BE FELT UNTIL LATE 1982.

BUSINESS SPENDING FOR PLANT AND EQUIPMENT ALSO MAY REMAIN SLUGGISH, EXCEPT OF COURSE FOR THE VERY STRONG ENERGY SECTOR. RECENT SURVEYS INDICATE LITTLE STRENGTH IN CAPITAL SPENDING PLANS, WHILE NEW EQUIPMENT ORDERS AND CAPITAL-CONSTRUCTION CONTRACTS HAVE SHOWN DECLINES RECENTLY, IN REAL TERMS. MEANWHILE, THE DOWNTURN IN HOUSING STARTS SHOULD BE TRANSLATED, AFTER THE USUAL LAG, INTO A CUTBACK IN SPENDING FOR NEW-HOME CONSTRUCTION. BUSINESS-INVENTORY SPENDING ALSO COULD WEAKEN, SINCE MUCH OF THE SECOND-QUARTER BUILDUP REPRESENTED AN UNWANTED ACCUMULATION OF STOCKS. AND IN ADDITION, THE EXPORT TRADE COULD WEAKEN IN COMING MONTHS, IN VIEW OF THE RECENT APPRECIATION OF THE DOLLAR, ALONG WITH THE SLOWDOWN IN ECONOMIC GROWTH ABROAD.

GOVERNMENT EXPENDITURES, IN REAL TERMS, MAY RISE RELATIVELY SLOWLY OVER THE NEXT YEAR. OUTSIDE THE DEFENSE AREA, FEDERAL-GOVERNMENT SPENDING SHOULD CONTRACT IN REAL TERMS, GIVEN THE BUDGET CUTS SCHEDULED FOR FISCAL 1982. STATE AND LOCAL GOVERNMENTS MEANWHILE ARE TRYING TO HOLD DOWN SPENDING, IN RESPONSE TO REDUCED INCOME FROM FEDERAL GRANTS AND TO SLOWER GROWTH OF

THEIR OWN TAX RECEIPTS. SO ON BALANCE, WE MAY EXPERIENCE LITTLE STIMULUS FROM EITHER THE PRIVATE OR PUBLIC SECTORS IN COMING MONTHS, EXCEPT OF COURSE FOR THE DEFENSE AND ENERGY INDUSTRIES.

OUTLOOK FOR PRICES

ON THE PRICE FRONT, THE OUTLOOK HAS BRIGHTENED CONSIDERABLY SO FAR IN 1981. AND EVEN THOUGH SOME BAD MONTHS MAY LIE AHEAD, WE APPEAR AT LEAST TO BE MOVING OUT OF THE DOUBLE-DIGIT INFLATION RANGE. THE CONSUMER-PRICE INDEX INCREASED AT A $8\frac{1}{2}$ -PERCENT ANNUAL RATE IN THE FIRST HALF OF 1981, COMPARED TO A $12\frac{1}{2}$ -PERCENT INCREASE IN 1980, AS A REFLECTION OF REDUCED MONEY GROWTH AND UNEXPECTEDLY FAVORABLE DEVELOPMENTS IN THE VOLATILE FOOD AND ENERGY SECTORS. ALSO, SCATTERED SIGNS APPEARED OF A SLOWING IN COST PRESSURES, AS PRODUCTIVITY SPURTED IN THE FIRST QUARTER AND AS WAGE PRESSURES DECREASED DURING THE SPRING MONTHS.

CAN WE EXPECT FURTHER DECELERATION IN PRICES? THE INDICATORS ARE SOMEWHAT MIXED. ON THE ONE HAND, THE CURRENT WEAKNESS IN WORLD OIL MARKETS ARGUES FOR PRICE STABILITY IN THAT SECTOR, ALTHOUGH THE ECONOMY WILL CONTINUE TO SUFFER FROM THE DOUBLING OF OIL PRICES OF THE PREVIOUS TWO YEARS. MOREOVER, WE SHOULD CONTINUE TO BENEFIT FROM THE RECENT IMPROVEMENT IN THE FOREIGN-EXCHANGE VALUE OF THE DOLLAR, WHICH HAS REDUCED THE PRICE OF IMPORTS AND ALSO CURBED INCREASES IN PRICES OF DOMESTIC GOODS THAT COMPETE WITH IMPORTS. ON THE OTHER HAND, FOOD PRICES MAY RISE MORE RAPIDLY IN COMING MONTHS AS SUPPLY CONDITIONS TIGHTEN IN SOME AREAS. ALSO, LABOR-COST PRESSURES COULD INTENSIFY,

REFLECTING THE WEAKENING OF PRODUCTIVITY THAT ALWAYS ACCOMPANIES ANY SLOWDOWN IN BUSINESS ACTIVITY.

STILL, WE SHOULD EMPHASIZE AGAIN THAT INFLATION TRENDS OVER THE LONG RUN LARGELY REFLECT PAST MONETARY-GROWTH TRENDS. BY THAT STANDARD, THEREFORE, THE PROSPECT LOOKS RELATIVELY FAVORABLE. HISTORY SHOWS THAT CHANGES IN MONEY-SUPPLY GROWTH DEFINITELY AFFECT THE INFLATION RATE OVER TIME, USUALLY WITH A LAG OF A YEAR-AND-A-HALF TO TWO YEARS. THE RECENT DECELERATION THUS SUGGESTS FURTHER PROGRESS ON THE PRICE FRONT OVER THE COMING PERIOD.

IMPLICATIONS FOR CREDIT MARKETS

A MAJOR DISTURBING ELEMENT IN THE CURRENT PICTURE, HOWEVER, IS THE STATE OF THE CREDIT MARKETS. THE STOCK MARKET AND (ESPECIALLY) THE BOND MARKET HAVE WEAKENED IN RECENT MONTHS, DESPITE THE BRIGHTENING PROSPECTS FOR PRICES AND ECONOMIC POLICY. AND THROUGHOUT THE ECONOMY, PEOPLE ARE DEMANDING TO KNOW WHY INTEREST RATES REMAIN AT SUCH STRATOSPHERIC LEVELS WHEN INFLATION RATES HAVE COME DOWN SO NOTICEABLY. THE ANSWER TO THIS PARADOX MAY BE FOUND, FIRST, IN THE AREA OF EXPECTATIONS, AND SECONDLY IN TERMS OF CREDIT-MARKET PRESSURES.

CONSIDER THE EXPECTATIONS ARGUMENT -- THE "ONCE BURNED, TWICE SHY" PHENOMENON. CREDIT-MARKET PARTICIPANTS REMEMBER VIVIDLY THE HISTORY OF THE MIDDLE AND LATE 1970'S -- WHEN THE INFLATION RATE DECLINED BY HALF, AND INTEREST RATES FELL CORRESPONDINGLY, ONLY TO BE FOLLOWED BY A SHARP REVERSAL OF RATES IN THE INFLATIONARY SPURT OF THE 1977-80 PERIOD. THIS

TIME, MARKET PARTICIPANTS ARE HOLDING BACK, DEMANDING A CONTINUED LARGE INFLATION PREMIUM, UNTIL THEY SEE SUSTAINED PROGRESS IN THE FIGHT AGAINST INFLATION.

THEIR FEARS HAVE BEEN REINFORCED BY THE CONTINUED PRESSURES ON CREDIT MARKETS FROM FEDERAL FINANCING DEMANDS. NET BORROWING BY THE FEDERAL GOVERNMENT AND FEDERALLY-ASSISTED AGENCIES REPRESENTED ONE-THIRD OF ALL FUNDS RAISED BY NONFINANCIAL SECTORS LAST YEAR, AND THE FEDERAL SHARE COULD REMAIN ALMOST THAT HIGH THIS YEAR. FOR EXAMPLE, IN THE FINAL QUARTER OF 1981, THE TREASURY PLANS TO BORROW A NEAR-RECORD \$30 BILLION TO \$33 BILLION. MUCH OF THIS BORROWING MAY REPRESENT "CROWDING OUT" OF OTHER BORROWERS -- HOUSEHOLDS, BUSINESSES, AND STATE AND LOCAL GOVERNMENTS, WHO CANNOT AFFORD TO PAY THE INTEREST RATES THAT THE FEDERAL GOVERNMENT IS WILLING AND ABLE TO PAY. SURELY, THIS MASSIVE FEDERAL PRESENCE IN CREDIT MARKETS MUST BE CONSIDERED A MAJOR CAUSE, ALONG WITH HIGH INFLATION, OF THE HIGH LEVEL OF INTEREST RATES.

SOME MARKET OBSERVERS FEAR THAT LARGE FEDERAL DEFICITS WILL CONTINUE TO UNDERMINE THE STRENGTH OF THE MARKET IN COMING YEARS. THOSE FEARS CAN BE TRACED IN TURN TO THE EXPANSION OF THE INDEXING TECHNIQUE TO THE REVENUE AS WELL AS THE SPENDING SIDE OF THE BUDGET. IN RECENT YEARS, LARGE BUDGET DEFICITS HAVE REFLECTED THE INFLATION-INDEXED UPSURGE IN PAYMENTS FOR SOCIAL SECURITY AND OTHER "ENTITLEMENT" PROGRAMS. (THESE PROGRAMS HAVE ACCOUNTED FOR MORE THAN TWO-THIRDS OF ALL BUDGET SPENDING, OUTSIDE OF DEFENSE AND INTEREST COSTS.) IN COMING YEARS,

FEDERAL REVENUES WILL WEAKEN, FIRST BECAUSE OF THE NEW TAX CUTS, AND LATER BECAUSE OF INFLATION INDEXING OF INDIVIDUAL INCOME TAXES. THUS, IF CONGRESS FAILS TO KEEP SPENDING UNDER CONTROL, DEFICITS COULD REMAIN HIGH -- EVEN IN A GROWING ECONOMY -- AND COULD CONTINUE TO KEEP CREDIT MARKETS UNDER PRESSURE.

CONCLUDING REMARKS

TO SUMMARIZE, WE'RE NOW SHOWING SOME PROGRESS IN FIGHTING INFLATION, PARTLY BECAUSE OF THE EASING OF OIL- AND FOOD-PRICE PRESSURES, BUT LARGELY BECAUSE OF SLOWER GROWTH OF MONEY AND CREDIT. BUT THE PROCESS OF SLOWING INFLATION THROUGH MONETARY RESTRAINT CAN LEAD TO STRAINS ON CERTAIN SECTORS OF THE ECONOMY, ESPECIALLY WHEN THE FEDERAL RESERVE CARRIES SO MUCH OF THE TASK OF DEALING WITH INFLATION. AS LONG AS STRONG CREDIT DEMANDS PERSIST, AND INFLATIONARY EXPECTATIONS REMAIN INTENSE, RESTRAINED MONETARY GROWTH MAY BE ACCOMPANIED BY HIGH INTEREST RATES AND FINANCIAL-MARKET STRAINS.

THESE FINANCIAL PRESSURES IMPOSE HARDSHIPS UPON CREDIT-DEPENDENT INDUSTRIES, SUCH AS HOUSING AND MUCH BUSINESS INVESTMENT --AND UPON THE VARIOUS REGIONS THAT SUPPLY SUCH INDUSTRIES. WE USED TO THINK THAT WE COULD TEMPORARILY EASE THEIR PROBLEMS THROUGH A SWITCH TO MONETARY STIMULUS AND A CONSEQUENT DROP IN INTEREST RATES. BUT OUR EXPERIENCE LAST FALL, AND AGAIN THIS PAST APRIL, SUGGESTS THAT WE CAN'T EVEN COUNT ON THAT RESULT ANYMORE -- THAT INCREASED MONEY GROWTH LEADS MARKET PARTICIPANTS TO PUSH RATES UP

(RATHER THAN DOWN) BECAUSE OF INCREASED FEARS OF FUTURE INFLATION.

DISCIPLINED MONETARY POLICY THUS IS A KEY ELEMENT IN THE NATION'S EFFORT TO CURB INFLATIONARY FORCES. HOWEVER, FISCAL AND REGULATORY POLICIES MUST CONTINUE TO SUPPORT THE FEDERAL RESERVE'S MONETARY EFFORTS. IN THIS REGARD, THE ADMINISTRATION'S SUCCESS IN GETTING TAX AND SPENDING REDUCTIONS THROUGH CONGRESS IS A VERY GOOD OMEN. BUT CONTINUED VIGILANCE IS NECESSARY TO ENSURE THAT FEDERAL SPENDING IS CONTROLLED AND THE BUDGET BROUGHT CLOSER TO BALANCE. ONLY THEN WILL WE SEE REDUCED PRESSURE ON FINANCIAL MARKETS, LESSENER EXPECTATIONS OF INFLATION, AND A LONG-AWAITED RETURN TO AN ENVIRONMENT OF NONINFLATIONARY GROWTH.

#