

READING COPY

DEFICITS AND INFLATION: THREATS TO A SUSTAINED RECOVERY

REMARKS OF
JOHN J. BALLE, PRESIDENT
FEDERAL RESERVE BANK OF SAN FRANCISCO

MEETING WITH COMMUNITY LEADERS
AND DIRECTORS, LOS ANGELES BRANCH
FEDERAL RESERVE BANK OF SAN FRANCISCO

BAKERSFIELD, CALIFORNIA
NOVEMBER 23, 1982

DEFICITS AND INFLATION: THREATS TO A SUSTAINED RECOVERY

THANK YOU FOR THIS OPPORTUNITY TO MEET WITH YOU. EACH TIME I VISIT BAKERSFIELD I AM IMPRESSED WITH THE VIGOR AND GROWTH THAT IS EVIDENT THROUGHOUT THE CENTRAL VALLEY. EVEN WHEN YOU ARE SUFFERING AN ECONOMIC DOWNTURN, ALONG WITH THE REST OF THE NATIONAL ECONOMY, THERE IS A SENSE OF PROGRESS AND OPTIMISM IN THIS AREA.

I APPRECIATE THE TIME I HAVE WITH YOU TODAY. I WOULD LIKE TO SHARE WITH YOU SOME THOUGHTS ABOUT WHAT THE FED HAS DONE AND IS TRYING TO DO, AND TO POINT OUT SOME OF THE THINGS THAT MUST BE DONE FURTHER -- BOTH BY THE FED AND BY OTHER IMPORTANT INSTITUTIONS -- TO IMPROVE THE ECONOMY OF OUR NATION AND OF THIS AREA.

ROLE OF DIRECTORS

BEFORE WE GET INTO THAT, HOWEVER, I'D LIKE TO PAY TRIBUTE TO AN OUSTANDING GROUP OF INDIVIDUALS -- LOS ANGELES' OWN BRUCE SCHWAEGLER AND HIS COLLEAGUES ON OUR RESERVE BANK'S LOS ANGELES BOARD OF DIRECTORS. I'D ALSO LIKE TO NOTE THAT A FORMER DIRECTOR IS WITH US TODAY AS WELL. RAY DEZEMBER IS A PROMINENT BUSINESSMAN AND BANKER IN BAKERSFIELD. HE SERVED TWO TERMS AS DIRECTOR OF THE LOS ANGELES BRANCH AND WAS A VERY VALUABLE MEMBER.

THE DIRECTORS AT OUR FIVE OFFICES ARE PERSONALLY INVOLVED WITH EACH OF THE MAJOR TASKS DELEGATED BY CONGRESS TO THE FEDERAL RESERVE.

THESE TASKS INCLUDE:

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, PARTICIPATION IN THE
DEVELOPMENT OF MONETARY POLICY.

WE ON THE DAILY FIRING LINE ARE FORTUNATE IN THE QUALITY
OF ADVICE AND COUNSEL WE GET FROM EACH OF THEM IN THESE
IMPORTANT AREAS.

OUR DIRECTORS CONSTANTLY HELP US IMPROVE THE LEVEL OF
CENTRAL-BANKING SERVICES, IN THE MOST COST-EFFECTIVE MANNER.
THIS IS A CRUCIAL ROLE, BECAUSE UNDER THE TERMS OF THE
MONETARY CONTROL ACT OF 1980 AND OTHER RECENT LEGISLATION,
THE FEDERAL RESERVE IS IN A NEW AND CHANGING OPERATING
ENVIRONMENT. FOR OVER A YEAR NOW, 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 REGIONS OF
OUR NINE-STATE DISTRICT AND IN VARIOUS SECTORS OF THE WESTERN
ECONOMY.

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.

THUS, OUR DIRECTORS SERVE A KEY ROLE IN MAKING THE FED SENSITIVE TO THE WIDE-RANGING INTERESTS OF OUR VAST AND DIVERSE ECONOMY, JUST AS THE CONGRESS ENVISIONED WHEN IT ESTABLISHED THE SYSTEM DURING PRESIDENT WOODROW WILSON'S TERM IN OFFICE. THAT VITAL ROLE IS REALLY APPRECIATED BY ME AND MY STAFF, AND I APPRECIATE THIS OPPORTUNITY TO PUBLICLY EXPRESS IT.

HIGH INFLATION, HIGH INTEREST RATES AND HIGH UNEMPLOYMENT

FOR A LONG TIME, TOO LONG, OUR NATIONAL ECONOMY HAS BEEN PLAGUED BY A HIGH RATE OF INFLATION, HIGH INTEREST RATES, AND HIGH UNEMPLOYMENT. THANKFULLY, WE HAVE SEEN A DRAMATIC DROP IN INFLATION OVER THE PAST YEAR, AND WE HAVE SEEN A DRAMATIC DROP IN INTEREST RATES OVER THE PAST FEW MONTHS. BOTH ARE STILL TOO HIGH, BUT THE IMPROVEMENT IS THERE. UNEMPLOYMENT, ON THE OTHER HAND, IS SPREADING GLOOM ALL OVER THE LAND. MUCH HAS BEEN DONE TO ALLEVIATE OUR ECONOMIC ILLS, BUT MUCH MORE NEEDS TO BE DONE.

MONETARY POLICY SINCE LATE 1979 HAS BEEN PRIMARILY CONCERNED WITH REDUCING THE LONG-TERM UPWARD TREND IN THE

RATE OF INFLATION. IN VIEW OF THE DRAMATIC DECLINE IN INFLATION RATES OVER THE PAST YEAR -- EVIDENCE OF THE SUCCESS OF THAT POLICY -- IT IS WORTHWHILE TO REMIND OURSELVES OF WHAT IS NOW HISTORY, BUT WHICH, IN FACT, WAS A VERY REAL AND IMMEDIATE FEAR ONLY THREE YEARS AGO. THAT IS, THE FEAR OF DOUBLE-DIGIT INFLATION.

IN THE FALL OF 1979, INFLATION WAS RATED AS THE NUMBER ONE CONCERN OF THE CITIZENS OF OUR COUNTRY -- AND WITH GOOD REASON. WE WERE LOOKING AT INFLATION RATES EXCEEDING TEN PERCENT.

WITH RATES OF THIS MAGNITUDE, AND HIGHER ONES IN PROSPECT, THE AVERAGE CITIZEN FEARED A SUBSTANTIAL DECREASE IN THE PURCHASING POWER OF HIS DOLLAR. WHILE SOME LABOR CONTRACTS IN THE U.S. HAD BUILT-IN ADJUSTMENTS FOR INFLATION, MANY WORKERS FOUND THEIR REAL TAKE-HOME PAY DECLINING. NOT ONLY WERE REAL WAGE AND SALARY INCREASES REDUCED BY INFLATION, INFLATION PUSHED MANY CITIZENS INTO HIGHER REAL TAX BRACKETS -- GREATLY DECREASING REAL SPENDABLE INCOME.

RISING INFLATION ALSO MEANT THAT THE AVERAGE AMERICAN WAS LOOKING AT A REDUCTION IN THE FUTURE REAL VALUE OF HIS PENSION, AND ALL ASSETS DENOMINATED IN NON-INDEXED DOLLARS. IN A NATION WHERE THE TOTAL NUMBER OF ELDERLY IS RAPIDLY INCREASING, THIS IS A GREAT PROBLEM.

FOR THE BUSINESSMAN, DOUBLE-DIGIT INFLATION MEANT SUBSTANTIAL DIFFICULTY IN PROJECTING FUTURE SALES, REVENUES

AND COSTS. IT BECAME PARTICULARLY DIFFICULT TO DETERMINE THE VIABILITY OF CONTEMPLATED INVESTMENTS. INFLATION CONTRIBUTED SIGNIFICANTLY TO THE 2.2 PERCENT DECLINE IN REAL BUSINESS-FIXED INVESTMENT BETWEEN 1979 AND 1980. IN OTHER WORDS, INFLATION WAS IN THE PROCESS OF DESTROYING JOB FORMATION AND PRODUCTIVITY IMPROVEMENTS. INTERNATIONALLY, THE DOLLAR WAS DECLINING IN STRENGTH. FOR EXAMPLE, IT WOULD BUY ONLY 1.63 SWISS FRANCS IN OCTOBER, 1979, A DECLINE OF 29 PERCENT FROM ITS LEVEL JUST TWO YEARS EARLIER.

A MAJOR BENEFICIARY OF INFLATION -- OF WHICH THERE ARE VERY FEW -- IS THE FEDERAL GOVERNMENT. THE FEDERAL GOVERNMENT IS A NET DEBTOR TO THE PRIVATE SECTOR. HENCE, INFLATION HELPS REDUCE THE REAL VALUE OF GOVERNMENT DEBT HELD BY PRIVATE CITIZENS. INFLATION IS, QUITE SIMPLY, A TAX ON ALL OF US. HOWEVER, IT IS TAXATION WITHOUT REPRESENTATION. CARRIED FAR ENOUGH, INFLATION CAN DESTROY A SOCIETY.

THIS UNCOMFORTABLE AND DISTRESSING SITUATION HAD NOT OCCURRED OVERNIGHT. IT HAD CREPT UP ON THIS NATION OVER A PERIOD OF MANY YEARS, ESPECIALLY IN THE 1970'S -- THE MOST INFLATIONARY DECADE IN OUR PEACETIME HISTORY. UNLIKE THE INFLATIONARY PERIOD OF 1973-74, DOUBLE-DIGIT INFLATION IN THE LATER 1970'S CANNOT BE BLAMED ON OIL PRICE SHOCKS. IT MUST BE BLAMED PARTLY ON OVER-OPTIMISTIC NATIONAL POLICY OBJECTIVES IN THE MID-1970'S AND PARTLY ON PROCEDURES BY WHICH THE FEDERAL RESERVE ATTEMPTED TO CONTROL INFLATION.

IN RESPONSE TO THESE PROBLEMS, THE FEDERAL RESERVE UNDERTOOK MAJOR CHANGES IN OCTOBER, 1979, IN BOTH ITS LONG-RUN POLICY GOALS AND ITS TOOLS FOR ACHIEVING THOSE GOALS. POLICIES WERE DESIGNED TO BRING DOWN THE RATE OF INFLATION GRADUALLY OVER THE NEXT SEVERAL YEARS. THE FEDERAL RESERVE CHANGED ITS OPERATING PROCEDURES FOR MONETARY CONTROL BY PLACING MUCH GREATER EMPHASIS ON THE RATE OF GROWTH OF MONEY AND CREDIT AND MUCH LESS EMPHASIS ON THE LEVEL OF INTEREST RATES.

THE RESULTS OF THESE CHANGES HAVE BEEN DRAMATIC INDEED. IN THE YEAR ENDED SEPTEMBER, 1982, CONSUMER PRICES (AS MEASURED BY THE PERSONAL CONSUMPTION EXPENDITURE DEFLATOR) INCREASED BY ONLY 5.3 PERCENT -- DOWN SHARPLY FROM THE PEAK OF 14 PERCENT REACHED IN 1980. WHOLESAL PRICE INFLATION FELL FROM 13.1 PERCENT IN THE YEAR ENDING OCTOBER, 1980, TO 3.6 PERCENT FOR THE YEAR ENDING OCTOBER, 1982.

THE IMPROVEMENT IN OUR DOMESTIC PRICE PERFORMANCE HAS BEEN MIRRORED IN THE INTERNATIONAL MARKET. THE U.S. DOLLAR IS NOW WORTH MORE THAN 2 SWISS FRANCS, AN APPRECIATION OF MORE THAN 29 PERCENT SINCE THE FALL OF 1979. BOTH DOMESTICALLY AND INTERNATIONALLY WE SEE SIGNS THAT THE VALUE OF OUR CURRENCY, WHICH THE FEDERAL RESERVE HAD DIRECT RESPONSIBILITY FOR PRESERVING, HAS IMPROVED.

STRUCTURAL DEFICITS

THERE ARE COSTS THAT ANY CENTRAL BANKER RECOGNIZES ASSOCIATED WITH FOLLOWING A GRADUAL ANTI-INFLATIONARY

MONETARY POLICY. THESE COSTS INVOLVE THE LOSS OF REAL OUTPUT AND INCREASE IN UNEMPLOYMENT. BUT THE DEPTH OF THIS RECESSION AND THE LOSS OF JOBS ASSOCIATED WITH IT WAS NOT ANTICIPATED. IN FACT, AS LATE AS SEPTEMBER OF LAST YEAR, THREE MONTHS AFTER THE RECESSION IS NOW RECOGNIZED OFFICIALLY TO HAVE BEGUN, NO MAJOR FORECASTER ANTICIPATED MORE THAN A MODEST DECLINE.

WHAT WAS NOT ANTICIPATED BEFOREHAND WAS THE EXTRAORDINARILY HIGH AND STUBBORN RESISTANCE OF INTEREST RATES. HISTORICALLY WE HAVE OBSERVED A CLOSE AND POSITIVE RELATIONSHIP BETWEEN CHANGES IN INTEREST RATES AND INFLATION. AND, GENERALLY, INTEREST RATES FALL IN RECESSIONS, SETTING THE FOUNDATIONS FOR THE RECOVERY. OUR EXPERIENCE THROUGH LAST SUMMER IS UNUSUAL IN LIGHT OF THIS HISTORICAL BEHAVIOR. DURING THE FIRST TWELVE MONTHS OF THE RECESSION, RATES GENERALLY ROSE RATHER THAN DECLINED. FOR INSTANCE, THE AAA CORPORATE BOND RATE BETWEEN JULY, 1981, AND JUNE, 1982, ROSE FROM 14.38 PERCENT TO 14.75 PERCENT, AND ONLY IN THE PAST SEVERAL MONTHS HAVE BEGUN TO DECLINE.

THIS UNUSUAL BEHAVIOR IS ASSOCIATED, IN MY VIEW, WITH THE MARKET'S PERCEPTIONS OF MONETARY AND FISCAL POLICIES. LET ME SPEND A MOMENT ON THIS POINT.

IN JULY, 1981, CONGRESS PASSED THE LARGEST TAX CUTS IN U.S. ECONOMIC HISTORY. THAT TAX CUT WAS ASSOCIATED

WITH ONLY A MODEST REDUCTION IN FEDERAL EXPENDITURES. WHILE THERE WAS A MAJOR REDUCTION IN SOCIAL PROGRAMS, THAT REDUCTION WAS ALMOST MATCHED BY AN INCREASE IN DEFENSE SPENDING. HENCE, THE TAX CUTS WERE NOT PARALLELED WITH SIMILAR REDUCTIONS IN FEDERAL EXPENDITURES. THE END RESULT WAS THE PROSPECT FOR MAJOR INCREASES IN THE FEDERAL DEFICIT OVER THE NEXT SEVERAL YEARS. SOME COMMENTATORS EVEN SUGGESTED THAT THE COMBINATION OF LARGE TAX CUTS, COUPLED WITH SIGNIFICANTLY SMALLER EXPENDITURE REDUCTIONS, MEANT THAT THE FEDERAL BUDGET WAS GOING TO BE STRUCTURALLY UNBALANCED. THAT IS, THE FEDERAL BUDGET WAS EXPECTED TO BE IN DEFICIT EVEN IF THE ECONOMY SHOWED A SIGNIFICANT RECOVERY OVER THE NEXT FEW YEARS.

THE PROSPECT OF LARGE FEDERAL DEFICITS OVER A SEVERAL YEAR PERIOD TENDS TO RAISE LONG-TERM INTEREST RATES. THIS EFFECT CAN OPERATE IN SEVERAL WAYS. FIRST, AS THE PRIVATE DEMAND FOR CREDIT RISES WITH THE BUSINESS CYCLE EXPANSION OVER THE NEXT FEW YEARS, AND THE GOVERNMENT DEMAND FOR CREDIT REMAINS HIGH, TOTAL DEMAND PRESSES UPON THE AVAILABLE SUPPLY OF NATIONAL SAVINGS, RAISING INTEREST RATES AND CROWDING OUT SOME PRIVATE SPENDING.

SECOND, STRUCTURAL GOVERNMENT DEFICITS OVER THE NEXT FEW YEARS CREATE GREAT CONCERN IN THE MINDS OF FINANCIAL MARKETS THAT THE FEDERAL RESERVE WILL EVENTUALLY BE FORCED TO MONETIZE THE DEFICITS BY EXCESSIVE AND HENCE INFLATIONARY GROWTH

IN THE MONEY SUPPLY. THE ASSOCIATED INCREASE IN INFLATION EXPECTATIONS ADDS TO THE INFLATION PREMIUM INCORPORATED IN INTEREST RATES.

LASTLY, UNCERTAINTY ABOUT THE SIZE OF FEDERAL DEFICITS AND CONSEQUENTLY ALSO ABOUT THE FUTURE COURSE OF MONETARY POLICY ADDS TO THE RISK PREMIUM IN LONG-TERM RATES EVEN WHEN THE CURRENT INFLATION RATE IS DECLINING. MARKETS REMEMBER THAT THE SHARP DECLINE IN INFLATION IN 1975-76 WAS ONLY TEMPORARY. THE SUBSEQUENT EASING OF MONEY LED TO ANOTHER ROUND OF DOUBLE-DIGIT INFLATION IN THE LATE 1970'S.

THESE DEFICIT-RELATED FACTORS INCREASE LONG-TERM RATES AND GREATLY REDUCE THE ABILITY OF BUSINESSES TO FUND LONG-TERM DEBT. THIS REQUIRES THE FUNNELLING OF SOME OF THE DEMAND FOR FUNDS INTO THE SHORT-END OF THE MARKET, TENDING TO INCREASE SHORT-TERM INTEREST RATES.

THE FEDERAL DEFICIT PICTURE HAS BEEN MODIFIED SINCE LAST AUGUST WHEN CONGRESS PASSED THE \$98.3 BILLION TAX INCREASE SPREAD OVER THE NEXT THREE YEARS, ALONG WITH FURTHER SPENDING CUTS SOUGHT BY PRESIDENT REAGAN. THE POSITIVE RESPONSE OF THE FINANCIAL MARKETS -- THE RISE IN STOCK PRICES AND THE FALL IN INTEREST RATES -- WAS GRATIFYING. THIS WAS CERTAINLY A STEP IN THE RIGHT DIRECTION.

HOWEVER, THERE IS CONSIDERABLE WORK AHEAD IF FEDERAL DEFICITS ARE TO BE BROUGHT UNDER CONTROL AND LONG-TERM INTEREST RATES FURTHER REDUCED TO REASONABLE LEVELS. FOR, EVEN WITH THESE TAX INCREASES AND SPENDING CUTS, DEFICITS

REMAIN HIGH BY HISTORICAL STANDARDS AND A GOOD DEAL OF UNCERTAINTY REMAINS IN REGARD TO THEIR SIZE.

THE FEDERAL DEFICIT FACING US NEXT YEAR ALONE IS ENORMOUS. ACCORDING TO ESTIMATES FROM THE CONGRESSIONAL BUDGET OFFICE, THE 1983 UNIFIED BUDGET DEFICIT MAY SWELL TO \$175 BILLION. TO PUT SOME PERSPECTIVE TO THE DEFICIT PROBLEM LET ME STATE THE EFFECTS ANOTHER WAY. TOTAL FUNDS RAISED BY THE FEDERAL GOVERNMENT AMOUNTED TO 23 PERCENT OF NET SAVINGS AVAILABLE FROM THE PRIVATE SECTOR AND STATE AND LOCAL GOVERNMENTS DURING THE 1970'S, WITH THE SHARE INCREASING DURING RECESSION YEARS. BUT NOW, ACCORDING TO MY STAFF, THE SHARE COULD RISE FROM 35 PERCENT IN THE 1980-81 PERIOD TO 62 PERCENT IN 1983.

THE KEY TO ECONOMIC RECOVERY

THE U.S. ECONOMY NOW IS DOMINATED BY HIGHLY DIVERGENT TRENDS. THE MARKETS IN WHICH PEOPLE SELL THEIR LABOR AND THEIR GOODS ARE DEPRESSED, WHILE THE MARKET IN WHICH THEY SELL THEIR FINANCIAL ASSETS IS STRONG. AS ONE HEADLINE WRITER PUT IT, "STOCKS JUMP AS JOBS SLUMP".

THE UNEMPLOYMENT RATE IN OCTOBER, OF 10.4 PERCENT, IS A 42-YEAR HIGH. PERHAPS A MORE REALISTIC MEASURE OF THE WEAKNESS IN THE ECONOMY IS THE EMPLOYMENT RATE. EMPLOYMENT STANDS AT 56.6 PERCENT OF THE ADULT POPULATION, WHICH IS DOWN FROM 59 PERCENT IN 1979, AND NOT QUITE AS LOW AS THE 55 PERCENT IT REACHED IN THE TROUGH OF THE 1974-75 RECESSION. THUS, THE ECONOMIC WEAKNESS WE CURRENTLY FACE IS SERIOUS.

HOWEVER, IT IS NOT IN ANY WAY IN THE SAME NATURE AS THE DISASTER THAT WE FACED IN THE 1930'S. FORTY-TWO YEARS AGO, THE EMPLOYMENT RATE WAS 47.6 PERCENT.

IN CONTRAST TO THE WEAKNESS IN THE MARKETS FOR GOODS AND LABOR, THE FINANCIAL MARKETS HAVE SHOWN DRAMATIC STRENGTH SINCE LAST SUMMER. STOCK PRICES HAVE RISEN BY 40 TO 50 PERCENT, 30-YEAR GOVERNMENT BONDS HAVE FALLEN FROM 14.6 PERCENT TO 10.6 PERCENT. THREE-MONTH TREASURY BILLS HAVE FALLEN FROM 12.5 PERCENT IN JUNE TO LESS THAN 8 PERCENT IN EARLY NOVEMBER.

THE KEY TO ECONOMIC RECOVERY IN 1983 AND BEYOND IS CRITICALLY DEPENDENT ON MAINTAINING A MOMENTUM OF DECLINE IN THE LONG-TERM INTEREST RATES. THE DECLINE WE'VE HAD UP TILL NOW CLEARLY SIGNALS THAT THERE WILL BE SOME STRENGTH IN THE ECONOMY IN THE MONTHS AHEAD. WHETHER THAT STRENGTH IS SUSTAINABLE DEPENDS UPON WHETHER THE DECLINE IN RATES IS ALSO SUSTAINABLE.

THERE ARE TWO FACTORS WHICH ARE IMPORTANT IN A SUSTAINABLE REDUCTION IN LONG-TERM INTEREST RATES. THE FIRST IS TO REDUCE THE FEDERAL GOVERNMENT DEFICIT. MY STAFF ESTIMATES THAT FOR EVERY \$25 TO \$30 BILLION REDUCTION IN DEFICITS OVER THE NEXT THREE FISCAL YEARS THAT LONG-TERM INTEREST RATES CAN BE REDUCED APPROXIMATELY ONE PERCENTAGE POINT. THE SECOND IS TO MAINTAIN PROGRESS IN A FURTHER REDUCTION OF THE ACTUAL INFLATION RATE, AS WELL AS PRESENTING A RENEWED RISE IN INFLATION EXPECTATIONS. THE LATTER DEPENDS IN LARGE PART ON FED CREDIBILITY.

I DEFINE THE REQUIREMENTS OF FEDERAL RESERVE CREDIBILITY AS SETTING VIABLE AND NON-INFLATIONARY RANGES OF GROWTH FOR MONEY AND CREDIT AND HITTING THOSE RANGES ON A YEARLY BASIS. IF NOT, OUR ONLY ALTERNATIVE IS TO HAVE A JUSTIFIABLY GOOD AND UNDERSTANDABLE REASON FOR DEPARTING FROM THEM. THIS REASON CANNOT SATISFY CENTRAL BANKERS ONLY; IT MUST ALSO SATISFY SKEPTICS IN THE FINANCIAL MARKETS. IN THIS MANNER, THE PUBLIC'S EXPECTATIONS OF INFLATION WILL COME DOWN AND LEAD THEM TO REDUCE THE INFLATION RISK THEY MUST FACTOR INTO TODAY'S INTEREST RATES. LONG-TERM RATES WILL THEN TEND TO DECLINE.

THE RECENT TEMPORARY OVERSHOOTING OF M1 TARGETS HAS THREATENED THE FEDERAL RESERVE'S HARD-WON CREDIBILITY. IN THE LAST FEW MONTHS, THE MONEY SUPPLY LOOKS LIKE IT WILL BE GROWING WELL IN EXCESS OF THE FEDERAL RESERVE'S TARGET. BUT THERE ARE GOOD REASONS FOR THIS.

IN JULY, CHAIRMAN VOLCKER ALERTED CONGRESS TO THE POSSIBILITY THAT THERE MAY BE SOME OVERSHOOTING OF M1 IN THE MONTHS AHEAD IF THE RECESSION CAUSES PEOPLE TO HOLD MORE PRECAUTIONARY MONEY BALANCES. THAT SEEMS TO HAVE BEEN A MAJOR FACTOR IN THE RAPID GROWTH OF M1 IN AUGUST, SEPTEMBER, AND OCTOBER. BEGINNING IN OCTOBER, THERE HAVE ALSO BEEN TECHNICAL PROBLEMS WITH INTERPRETING THE M1 MEASURE OF MONEY SUPPLY. THESE PROBLEMS INCLUDE THE MATURATION OF \$35 BILLION OF ALL SAVERS CERTIFICATES WHICH HAVE BEEN CLASSIFIED TEMPORARILY AS M1 IN OCTOBER AND NOVEMBER.

MOREOVER, STARTING IN DECEMBER, THE DEPOSIT TAKING INSTITUTIONS (MOSTLY BANKS AND SAVINGS AND LOANS) WILL BE ALLOWED TO CREATE DEPOSIT ACCOUNTS THAT COMPETE DIRECTLY WITH MONEY MARKET MUTUAL FUNDS AND CAN BE USED FOR WRITING CHECKS. THE NEW FINANCIAL INSTRUMENT WILL TEND TO DRAW FUNDS FROM TRADITIONAL CHECKING ACCOUNT BALANCES (COUNTED IN M1) INTO THE DEPOSITORY INSTITUTIONS' RELATED MONEY MARKET FUNDS (WHICH MAY NOT BE COUNTED IN M1).

CLEARLY, THE FINANCIAL MARKET HAS REACTED POSITIVELY TO THE TEMPORARY OVERSHOOT OF M1 TARGETS. THE STOCK MARKET SURGED TO NEW HIGHS AND LONG- AND SHORT-TERM INTEREST RATES HAVE DROPPED SUBSTANTIALLY SINCE EARLY OCTOBER. THE FINANCIAL MARKET IS COGNIZANT OF THE ISSUES FACING THE FEDERAL RESERVE AND ITS VOTE OF CONFIDENCE IS REASSURING. I CAN REASSURE YOU THAT THIS VOTE IS NOT MISPLACED -- WE HAVE NOT ABANDONED OUR LONG-TERM GOAL OF GRADUALLY REDUCING INFLATION. WITH A RECESSION CONTINUING INTO THE SECOND HALF OF 1982, IT IS IMPORTANT THAT THE FED AVOID EXCESSIVE RESTRICTIONS REGARDING THE PROPER MEASURE OF MONEY. IT IS IN THIS CONTEXT THAT ONE MUST INTERPRET THE RAPID GROWTH OF MONEY SINCE AUGUST.

THE ECONOMY -- STATUS AND OUTLOOK

IN TERMS OF THE NATIONAL ECONOMY, THE OUTLOOK IS MIXED. ECONOMIC SIGNALS IN SEPTEMBER AND OCTOBER POINT TOWARD FEW INDICATIONS OF RECOVERY. WE HAD A SLUGGISH GROWTH RATE OF 0.8 PERCENT IN REAL GNP IN THE THIRD QUARTER. THE UNEMPLOYMENT RATE OF 10.4 PERCENT EMPHASIZED THAT WEAKNESS.

ON THE OTHER HAND, NEW ORDERS FOR NONDEFENSE CAPITAL GOODS ROSE 4.7 PERCENT IN SEPTEMBER. WHILE HOUSING STARTS IN OCTOBER INCREASED BY ONLY 1 PERCENT, NEW BUILDING PERMITS SHOWED AN 18 PERCENT GAIN. INFLATION CONTINUED TO MODERATE AND THE INDEX OF LEADING ECONOMIC INDICATORS, A HISTORICALLY VALID INDICATOR OF ECONOMIC RECOVERY, ROSE .5 PERCENT IN SEPTEMBER FOR THE FIFTH INCREASE IN SIX MONTHS.

CONSUMERS GENERALLY SUPPLY THE INITIAL IMPETUS TO A RECOVERY, AND THEY HAVE SHOWN SOME SIGNS OF ACTIVITY. RETAIL SALES HAVE SHOWN SLIGHT IMPROVEMENT. HOUSEHOLD BUYING POWER HAS BEEN ENHANCED BY THE \$37 BILLION ADDITION TO THE INCOME STREAM FROM THE COMBINATION OF THE 10 PERCENT INCOME TAX REDUCTION AND THE 7½ PERCENT INCREASE IN SOCIAL SECURITY BENEFITS EFFECTIVE LAST JULY 1.

COUPLED WITH RECENT INCREASES IN PERSONAL INCOME, THE DECLINE IN INFLATION IN THE LAST YEAR HAS INCREASED REAL PURCHASING POWER. RELATIVE TO INCOME, HOUSEHOLD CREDIT IS NOT EXCESSIVE, AND HAS CONSIDERABLE ROOM FOR EXPANSION. THE RECENT DECLINE IN INTEREST RATES SHOULD PROVIDE SOME ADDITIONAL BOOST TO THE DEMAND FOR DURABLE GOODS BY HOUSEHOLDS.

BECAUSE OF THE UNUSUALLY HIGH REAL INTEREST RATES WE HAVE SEEN IN THE LAST TWO YEARS, THE U.S. DOLLAR HAS BEEN VERY STRONG IN THE FOREIGN EXCHANGE MARKETS. WHILE THIS HAS MADE FOREIGN IMPORTS CHEAPER AND HAS ATTRACTED CAPITAL FROM ABROAD, IT HAS ALSO MEANT THAT OUR INDUSTRIES HAVE HAD A ROUGH TIME COMPETING BOTH AT HOME AND ABROAD. THE FOREIGN TRADE PICTURE SHOULD IMPROVE AS INTEREST RATES DECLINE AND THE

EXCHANGE VALUE OF THE DOLLAR APPROACHES THE VALUE DETERMINED BY RELATIVE INTERNATIONAL PRICE LEVELS.

OVERALL, IT IS EXPECTED THAT THE RECOVERY WILL BE A SLOW ONE. EXCEPT FOR DEFENSE SPENDING, THE CONSUMPTION SECTOR SHOULD BE THE FIRST TO SHOW ANY MAJOR IMPROVEMENT THIS YEAR. RESIDENTIAL INVESTMENT WILL BE AIDED SOMEWHAT BY THE REDUCED LONG-TERM RATES AND GROWTH IN PERSONAL INCOME. HOWEVER, BUSINESS-FIXED INVESTMENT IS NOT EXPECTED TO SHOW POSITIVE GROWTH UNTIL THE SECOND HALF OF 1983.

IMPLICATIONS FOR BAKERSFIELD AND THE CENTRAL VALLEY

THE ECONOMIC SITUATION IN THE CENTRAL VALLEY EXEMPLIFIES THE KEY POINTS I HAVE JUST MADE. I WILL DIRECT MY COMMENTS AT KERN COUNTY BECAUSE IT IS CONSISTENTLY ONE OF THE THREE MOST PRODUCTIVE AGRICULTURAL COUNTIES IN THE UNITED STATES AND IS ALSO THE LEADING PETROLEUM PRODUCING COUNTY IN THE NATION.

THE FOUR MAIN EMPLOYERS IN KERN COUNTY ARE GOVERNMENT, AGRICULTURE, THE RETAIL TRADE, AND THE SERVICE INDUSTRIES.

GOVERNMENT JOBS ACCOUNT FOR ABOUT 19 PERCENT OF ALL EMPLOYMENT IN POSITIONS AT THE FEDERAL, STATE, COUNTY, AND LOCAL LEVELS. THE FEDERAL GOVERNMENT HAS CUT BACK IN ALL AREAS EXCEPT THAT OF DEFENSE AND IT IS IN THIS AREA THAT KERN COUNTY MAY STAND TO BENEFIT. BOTH EDWARDS AIR FORCE BASE AND CHINA LAKE NAVAL WEAPONS CENTER ARE LOCATED IN HERE AND SHOULD BENEFIT SHORTLY FROM INCREASES IN DEFENSE SPENDING. THIS SPENDING WILL, IN TURN, PROVIDE A BOOST TO KERN COUNTY'S GENERAL ECONOMY.

ANOTHER 19 PERCENT OF THOSE EMPLOYED IN KERN COUNTY WORK IN THE AGRICULTURE INDUSTRY. COTTON AND RAISINS ARE KEY CROPS, AND CITRUS FRUITS ARE EXPECTED TO BECOME MORE IMPORTANT AS LAND DEVOTED TO CITRUS CROPS ELSEWHERE IN THE STATE IS DISPLACED BY RESIDENTIAL EXPANSION.

THE OUTLOOK FOR THE FARM SECTOR, IN GENERAL, HAS NOT BEEN GOOD THIS YEAR. NET FARM INCOMES HAVE, IN FACT, DECLINED OVER THE PAST TWO YEARS, AND LITTLE IMPROVEMENT IS FORECAST IN 1983. FALLING INTEREST RATES AND THE RELATIVE STABILITY IN FUEL AND CHEMICAL COSTS WILL HELP, BUT EXISTING DEBT AND CURRENT HIGH OPERATING COSTS ARE EXPECTED TO CURB FARM EXPANSION FOR THE REST OF THE YEAR.

FOREIGN MARKETS ARE ALSO IMPORTANT FOR AN UNDERSTANDING OF THIS REGION'S ECONOMY. ABOUT ONE THIRD OF THE TONNAGE OF AGRICULTURAL CROPS HARVESTED IN CALIFORNIA IS EXPORTED. A MAJOR EXPORT CROP, AND AN IMPORTANT ONE IN KERN COUNTY, IS COTTON. EIGHTLY PERCENT OF CALIFORNIA'S COTTON IS SHIPPED TO THE FAR EAST TO BE PROCESSED INTO CLOTH. THIS YEAR, EXPORTS WILL BE HURT BY THE RELATIVE STRENGTH OF THE DOLLAR IN THE FOREIGN EXCHANGE MARKET.

FUTURE EMPLOYMENT GAINS ARE EXPECTED TO COME FROM THE PETROLEUM INDUSTRY AS WELL AS THE DEFENSE INDUSTRY. 1981 WAS A RECORD OIL DRILLING YEAR AND YIELDED JOB INCREASES OF 18 PERCENT. PRODUCTION INCREASED 4.5 PERCENT THE FIRST FIVE MONTHS OF THIS YEAR BUT DRILLING ACTIVITY HAS SLOWED SINCE THEN. THE EXPECTATION, NOW, IS THAT PRODUCTION WILL

STAGNATE FOR THE NEAR TERM BECAUSE OF LOWER OIL PRICES AND A WEAKENED DEMAND. NEVERTHELESS, DRILLING ACTIVITY SHOULD INCREASE OVER THE LONG TERM.

CONSOLIDATING THE GAINS

IT HAS BEEN A LONG AND HARD ROAD TO MAKE THE GAINS THAT HAVE BEEN MADE. INFLATION AND INTEREST RATES HAVE BEEN SHARPLY REDUCED. THEY NEED TO BE REDUCED FURTHER. UNEMPLOYMENT HAS SURGED TO THE FORE AS THE MOST PRESSING PROBLEM.

AS WE CONTINUE TO MOVE IN THE RIGHT DIRECTION, PUBLIC CONFIDENCE AND FAITH IN THE LONG-RANGE CREDIBILITY OF OUR MONETARY POLICY IS IMPORTANT. IMPORTANT TOO IS CONTINUING EMPHASIS ON REDUCTION OF THE STRUCTURAL DEFICITS. ONLY IN THIS WAY CAN THE PRIVATE SECTOR BE ENCOURAGED TO UNDERTAKE THE CAPITAL INVESTMENT NECESSARY TO CREATE JOBS.

THE PRESSING CHALLENGE IS TO CONTINUE TO CUT PROSPECTIVE FEDERAL DEFICITS AND TO CONTINUE TO LOWER LONG-RUN INFLATION EXPECTATIONS.

A SUSTAINABLE RECOVERY REQUIRES BOTH MONETARY AND FISCAL DISCIPLINE. YOUR UNDERSTANDING AND SUPPORT OF THESE REQUIREMENTS IS IMPORTANT. WE IN THE FED MUST CONTINUE TO EARN YOUR RESPECT FOR THE CREDIBILITY OF MONETARY POLICY AND WE INTEND TO DO THAT. ONLY IN THESE WAYS CAN THE ENVIRONMENT BE CREATED IN WHICH BUSINESSMEN HAVE SUFFICIENT CONFIDENCE TO INVEST IN THE FUTURE AND THE U.S. ECONOMY CAN HAVE STABLE GROWTH WITHOUT INFLATION.

#