

THE FEDERAL RESERVE
AND THE BUSINESS OUTLOOK

REMARKS OF
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MEETING WITH
SEATTLE COMMUNITY LEADERS

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INTRODUCTION

I APPRECIATE THIS OPPORTUNITY TO DISCUSS WITH YOU THE OUTLOOK FOR THE REGIONAL AND NATIONAL ECONOMY, AND TO SHARE WITH YOU MY PERCEPTIONS OF THE POTENTIAL PROBLEMS AHEAD. YOU MAY RECALL A PLAY FROM THE 1960'S CALLED "BEEN DOWN SO LONG IT LOOKS LIKE UP TO ME." THIS, I'M SURE, WAS THE SENTIMENT OF MANY OF US OVER THE PAST YEAR AS BOTH THE U.S. AND WASHINGTON ECONOMIES WENT THROUGH SOME PRETTY WRENCHING TIMES. STILL, A REVIEW OF THE RECENT BUSINESS AND FINANCIAL NEWS SUGGESTS THAT WE'VE ACCOMPLISHED A GREAT DEAL LATELY IN CLEARING THE ECONOMIC LANDSCAPE OF ONE OF OUR MOST SERIOUS PROBLEMS -- INFLATION -- ALTHOUGH OF COURSE THE JOB IS FAR FROM FINISHED. SPECIFICALLY, OUR POLICY ACTIONS HAVE CUT THE RATE OF INFLATION IN HALF SINCE 1981, AND IN THE PROCESS ESTABLISHED THE BASE FOR A SUBSTANTIAL BUSINESS RECOVERY. YET UNEMPLOYMENT AND FINANCIAL PROBLEMS CONTINUE TO PLAGUE THE U.S. AND WORLD ECONOMIES WHILE THE FINANCING OF A MASSIVE FEDERAL DEFICIT HAMPERS OUR TWO-FOLD TASK OF FOSTERING THE RECOVERY AND CURBING A RESURGENCE OF INFLATION.

STRENGTHS AND WEAKNESSES

REDUCED INFLATION REPRESENTS OUR STRONGEST RECENT ACHIEVEMENT. INDEED, IT IS A REMARKABLE ACHIEVEMENT IN LIGHT OF WHAT WENT BEFORE -- THAT IS, A SEEMINGLY UNSTOPPABLE PRICE SPIRAL THAT BADLY UNDERMINED THE ECONOMY THROUGHOUT THE PAST DECADE. LAST YEAR, FOR EXAMPLE, THE CPI AND PRODUCER PRICE INDICES ROSE BY ABOUT 4 PERCENT AND 3.5 PERCENT RESPECTIVELY (YEAR OVER YEAR), OR LESS THAN ONE-THIRD THEIR RATES OF INCREASE IN 1980. DURING THE FIRST FOUR MONTHS OF THIS YEAR THE CPI ROSE AT APPROXIMATELY A TWO PERCENT ANNUAL RATE, WHILE THE PRODUCER PRICE LEVEL HAS ACTUALLY FALLEN FROM DECEMBER TO APRIL.

AS THE INFLATION NUMBERS CONTINUE TO BRING GOOD NEWS, ATTENTION IS BEING INCREASINGLY FOCUSED ON THE ECONOMY'S ABILITY TO PULL OUT OF THE SEVERE RECESSION WE SUFFERED LAST YEAR. THE INDEX OF LEADING ECONOMIC INDICATORS HAS BEEN MOVING UPWARD SINCE LAST SEPTEMBER, AND OVER THE THREE MONTHS SINCE JANUARY HAS SCORED A VERY IMPRESSIVE GAIN. BUTTRESSING THAT EVIDENCE, REAL GNP GROWTH AT 2.5 PERCENT IN THE FIRST QUARTER OF THIS YEAR IS THE STRONGEST IT HAS BEEN IN ALMOST TWO YEARS. ALSO, THE UNEMPLOYMENT RATE FELL FROM 10.8 PERCENT IN DECEMBER TO 10.2 PERCENT IN APRIL AS EMPLOYMENT INCREASED SIGNIFICANTLY FOR THE FIRST TIME IN SEVEN MONTHS, WHILE THE AVERAGE WORK WEEK IN MANUFACTURING AND FACTORY OVERTIME MOVED BACK TO LEVELS THAT PREVAILED BEFORE THE RECESSION.

THUS, IT SEEMS CLEAR THAT AN ECONOMIC UPTURN IS UNDERWAY. THE IMPORTANT QUESTION AT THIS POINT IS WHAT FACTORS WILL BE CRITICAL IN SUSTAINING THE RECOVERY. IN MY VIEW, INTEREST RATES WILL PLAY A KEY ROLE, AND I SHALL RETURN TO THIS POINT AFTER DISCUSSING WHAT I THINK IS THE MOST LIKELY OUTLOOK FOR THE U.S. AND WASHINGTON ECONOMIES.

1983 OUTLOOK FOR NATION

REAL GNP FOR THE U.S. AS A WHOLE COULD GROW CLOSE TO 5 PERCENT OVER THE COURSE OF THIS YEAR, WHICH IS ALSO THE ADMINISTRATION'S REVISED FORECAST. BUSINESS-FIXED INVESTMENT SPENDING AND NET EXPORTS, BECAUSE OF CURRENT HIGH LEVELS OF EXCESS PLANT CAPACITY AND A CONTINUED STRONG FOREIGN EXCHANGE VALUE OF THE DOLLAR, RESPECTIVELY, ARE NOT EXPECTED TO PROVIDE ANY STRENGTH TO AGGREGATE DEMAND THIS YEAR. IN CONTRAST, CONSUMER SPENDING IS LIKELY TO MAKE A STRONG CONTRIBUTION AFTER ITS DISAPPOINTING SHOWING LAST YEAR. REAL CONSUMER INCOMES LOOK MUCH STRONGER THAN BEFORE, REFLECTING SUCH FACTORS AS A SUBSTANTIAL SLOWING OF THE RISE IN CONSUMER PRICES, IMPROVEMENT IN EMPLOYMENT, AND SOME EXPECTED AS WELL AS UNEXPECTED GAINS IN AFTER-TAX INCOMES.

THUS, HOUSEHOLDS CAN LOOK FORWARD TO THE MUCH-HERALDED \$35 BILLION MID-YEAR TAX CUT, AFTER AN UNEXPECTEDLY LARGE PACKAGE OF REFUND CHECKS THIS SPRING, MOSTLY REPRESENTING OVERLY-LARGE WITHHOLDINGS LAST YEAR. CURRENTLY, REFUNDS ARE RUNNING AT A RATE THAT SUGGESTS TOTAL REFUNDS COULD ULTIMATELY HIT \$30 BILLION. MOREOVER, DECLINING OIL PRICES COULD ADD AS MUCH AS ONE PERCENT TO CONSUMERS' REAL PURCHASING POWER IN 1983.

HOUSEHOLD BALANCE SHEETS ALSO SHOW A SUBSTANTIAL IMPROVEMENT. HOUSEHOLD WEALTH JUMPED BY \$300 BILLION AS A RESULT OF THE SPARKLING RALLY IN THE STOCK MARKET OVER THE PAST EIGHT MONTHS. WITH INTEREST RATES DECLINING AND THE CONSUMER-DEBT BURDEN AT THE LOWEST LEVEL OF THE LAST DECADE, HOUSEHOLDS HAVE EVEN MORE INCENTIVES TO START SPENDING AGAIN. THIS POTENTIAL WAS TRANSLATED INTO A SIGNIFICANT RISE IN RETAIL SALES IN MARCH AND APRIL.

ALL IN ALL, WE CAN EXPECT A SOLID RECOVERY THIS YEAR, BUT CERTAINLY NO BOOM. IF WE NEED A REMINDER OF THE DIFFERENCE BETWEEN RECOVERY AND BOOM, I SUGGEST A LOOK AT THE CURRENT DISTRESSINGLY HIGH UNEMPLOYMENT FIGURES. WITH RECOVERY, THE JOBLESS RATE SHOULD COME DOWN OUT OF DOUBLE-DIGIT TERRITORY, BUT WE'LL STILL BE LEFT WITH A VERY HIGH LEVEL OF "STRUCTURAL" UNEMPLOYMENT IN THOSE INDUSTRIES AND REGIONS THAT HAVE LOST THEIR COMPETITIVE EDGE IN WORLD MARKETS. ROUGHLY 2½ MILLION PEOPLE HAVE BEEN ON THE JOBLESS ROLLS FOR SIX MONTHS OR MORE -- OVER FOUR TIMES THE NUMBER OF LONG-TERM UNEMPLOYED IN LATE 1979, FOR EXAMPLE. BUT THEIR PROBLEMS WON'T BE SOLVED BY BROAD-SCALE STIMULATIVE MEASURES OR A NORMAL CYCLICAL RECOVERY; INSTEAD, THEY'LL NEED RETRAINING AND OTHER SPECIFIC PROGRAMS DESIGNED TO GET THEM BACK ON THE PRODUCTION LINE.

OUTLOOK: WASHINGTON STATE

THE WASHINGTON ECONOMY HAS BEEN ON THE RECOVERY PATH SINCE THE FALL OF LAST YEAR, AS EVIDENCED BY THE ONE PERCENTAGE POINT DROP IN THE STATE'S UNEMPLOYMENT RATE FROM OCTOBER OF LAST YEAR TO JUST UNDER 12 PERCENT IN MARCH. ONE BRIGHT SPOT SO FAR THIS YEAR HAS BEEN THE LUMBER INDUSTRY. THE UPTURN IN NATIONAL HOME-BUILDING ACTIVITY THAT BEGAN LAST SUMMER PUSHED UP LUMBER PRODUCTION AND PRICES DURING THE FIRST QUARTER OF 1983 TO WELL ABOVE LEVELS OF A YEAR AGO. THUS, IN THE FIRST QUARTER SOFTWOOD LUMBER PRODUCTION WAS UP 46 PERCENT FROM THE SAME PERIOD LAST YEAR, WHILE LUMBER PRICES WERE UP AN AVERAGE OF 11 PERCENT. THE LOCAL HOME BUILDING INDUSTRY HAS CONTRIBUTED TO THIS UPSWING, WITH AN 84 PERCENT INCREASE IN THE NUMBER OF PERMITS ISSUED IN THE FIRST QUARTER OF 1983 COMPARED WITH THE SAME PERIOD LAST YEAR.

IN THE AEROSPACE INDUSTRY, DEFENSE ORDERS HAVE CONTINUED TO GROW THROUGH THE FIRST QUARTER OF THIS YEAR, BUT COMMERCIAL AIRCRAFT ORDERS HAVE BEEN RUNNING WELL BELOW LAST YEAR'S LEVELS. AIRLINE TRAFFIC NATIONWIDE HAS TURNED UP RECENTLY, AND FURTHER IMPROVEMENT CAN BE EXPECTED OVER THE REMAINDER OF THE YEAR. NEVERTHELESS, IT MAY TAKE UNTIL NEXT YEAR BEFORE AIRLINES' FINANCIAL POSITIONS HAVE IMPROVED ENOUGH FOR THEM TO BEGIN REPLACING THEIR OLDER EQUIPMENT WITH THE NEW GENERATION OF AIRCRAFT. CRITICAL TO THIS PROCESS WILL BE THE EXTENT TO WHICH FURTHER PROGRESS CAN BE MADE IN LOWERING INTEREST RATES, A TOPIC WHICH I TURN TO NEXT.

HIGH INTEREST RATE SYNDROME

DESPITE ALL THE PLUS SIGNS IN THE OUTLOOK, RECOVERY IN THE NATIONAL AND REGIONAL ECONOMIES CANNOT BE GUARANTEED. CURRENT HIGH LEVELS OF INFLATION-ADJUSTED, OR REAL, INTEREST RATES, REMAIN A MATTER OF SOME CONCERN. AS YOU'VE NO DOUBT NOTICED, MARKET INTEREST RATES HAVE DECLINED SHARPLY SINCE LAST SUMMER. THE PRIME BUSINESS-LOAN RATE, AT 10½ PERCENT, FOR

EXAMPLE, IS ONLY HALF WHAT IT WAS AT ITS 1981 PEAK. BUT INFLATION HAS DECLINED AS RAPIDLY AS MOST LOAN RATES, AND THAT MEANS THAT REAL INTEREST COSTS FOR HOUSEHOLDS AND BUSINESSES HAVE NOT COME DOWN SUBSTANTIALLY. MOREOVER, THE IMPLICATIONS OF THESE HIGH REAL RATES ARE NOT CONFINED TO THEIR DIRECT EFFECTS ON BUSINESS AND CONSUMER SPENDING. HIGH REAL INTEREST RATES ATTRACT MASSIVE FUNDS FROM ABROAD, CAUSING THE DOLLAR TO BE OVERVALUED. THIS MEANS THAT IMPORTS ARE ENCOURAGED AND EXPORTS DISCOURAGED -- WHICH IN TURN MEANS CONTINUED DISTRESS FOR SUCH BASIC INDUSTRIES AS STEEL, AUTOS, AND AGRICULTURE.

THE FINANCIAL MARKETS ARE TRYING TO TELL US SOMETHING AND, AS USUAL, SOME POLITICAL FIGURES ARE TRYING TO SHOOT THE MESSENGER. THE MESSAGE IS QUITE SIMPLE: UNDERLYING CREDIT DEMANDS ARE SO STRONG TODAY THAT ONLY A RELATIVELY HIGH LEVEL OF INTEREST RATES WILL ALLOCATE THE AVAILABLE FUNDS AND SCREEN OUT LESS CREDIT-WORTHY BORROWERS. TEMPORARILY, MORE CREDIT DEMANDS COULD BE SATISFIED AT LOWER SHORT-TERM RATES IF THE FEDERAL RESERVE FLOODED THE MARKET WITH LIQUIDITY. BUT SUCH AN AGGRESSIVELY EASY POLICY WOULD LEAD NOT ONLY TO A RESURGENCE OF INFLATION DOWN THE ROAD, BUT ALSO TO HIGHER INFLATION EXPECTATIONS AND, THEREFORE, TO HIGHER LONG-TERM INTEREST RATES WITHIN A VERY SHORT TIME.

THE SOURCE OF THE PROBLEM IS THE FEDERAL GOVERNMENT'S MASSIVE CREDIT DEMANDS, AS IS NOW RECOGNIZED BY ALMOST EVERYONE INCLUDING CONGRESSIONAL LEADERS AND ADMINISTRATION OFFICIALS. THE TREASURY WAS IN THE MARKET FOR ABOUT \$56 BILLION LAST QUARTER. THIS QUARTER IT WILL PROBABLY NEED \$41 BILLION MORE, WHEREAS IT NORMALLY RUNS A SUBSTANTIAL SURPLUS DURING THE APRIL-JUNE TAX PAYING PERIOD. INDEED, THE FEDERAL GOVERNMENT SHOULD BE MOVING TOWARD A SURPLUS IN ITS ACCOUNTS AS THE RECOVERY PROCEEDS, TO MAKE ROOM FOR INCREASED PRIVATE CREDIT DEMANDS IN THE FINANCIAL MARKETS -- BUT INSTEAD IT WILL BE POSTING A SERIES OF RECORD DEFICITS. THE PROJECTED

UNIFIED BUDGET DEFICITS WILL BE ENORMOUS: AN ESTIMATED \$208 BILLION IN FISCAL 1983, WITH A RANGE OF \$150 BILLION TO \$202 BILLION IN FISCAL 1984, DEPENDING ON THE FINAL OUTCOME OF THE CURRENT DEBATE IN CONGRESS ON NEXT YEAR'S BUDGET. THESE DEFICITS COULD AMOUNT TO AS MUCH AS 85 PERCENT OF AVAILABLE NET SAVINGS FROM THE PRIVATE SECTOR AND THE SURPLUSES OF STATE AND LOCAL GOVERNMENTS. THIS WILL LEAVE LITTLE ROOM FOR NET PRIVATE INVESTMENT, WHICH IS THE KEY TO GROWTH IN NEW HOUSING AND BUSINESS CAPITAL. THESE DEFICITS OF COURSE WILL BE FINANCED. THE FEDERAL GOVERNMENT, WHICH IS NOT SUBJECT TO THE CONSTRAINTS OF A PROFIT/LOSS STATEMENT, WILL GET WHATEVER IS NEEDED SIMPLY BY OUTBIDDING PRIVATE BORROWERS FOR THE AVAILABLE SUPPLY OF FUNDS. THIS "CROWDING-OUT" OF PRIVATE CREDIT NEEDS, AS IT IS CALLED, WILL BE ACCOMPLISHED BY HIGH INTEREST RATES, WHICH IS THE MARKET'S WAY OF ALLOCATING CREDIT WHEN DEMAND EXCEEDS THE AVAILABLE SUPPLY.

FEDERAL RESERVE'S QUANDARY

IN THIS SITUATION, THE FEDERAL RESERVE HAS BEEN HANDED THE UNENVIABLE TASK OF SQUARING THE CIRCLE. MANY CONGRESSMEN HAVE DEMANDED THAT THE FED IGNORE MONEY-GROWTH CONSIDERATIONS -- ALTHOUGH THAT COULD MEAN A LATER UPSURGE IN INFLATION -- AND DO WHATEVER IS NECESSARY TO BRING INTEREST RATES DOWN TO LOWER LEVELS IMMEDIATELY. IN FACT, SOME MEMBERS HAVE INTRODUCED SPECIFIC LEGISLATION TO THAT EFFECT. IN CONTRAST, MANY MONETARIST ECONOMISTS HAVE DEMANDED THAT THE CENTRAL BANK IGNORE INTEREST-RATE CONSIDERATIONS -- ALTHOUGH THAT MIGHT MEAN A WEAK OR ABORTED RECOVERY -- AND ADHERE TO STRICT MONEY-GROWTH TARGETS IN THE PERIOD AHEAD. SOME, INDEED, BELIEVE THAT THE FED HAS ALREADY LET THE INFLATIONARY CAT OUT OF THE BAG IN ITS ATTEMPT TO SUPPORT THE ECONOMIC RECOVERY BECAUSE THE MONEY SUPPLY GREW RAPIDLY AT A 15.9 PERCENT ANNUAL RATE DURING THE EIGHT MONTHS, AUGUST THROUGH MARCH, BEFORE SLOWING DOWN SHARPLY IN APRIL.

FEDERAL RESERVE CHAIRMAN VOLCKER RESPONDED TO BOTH THESE CHARGES IN HIS SEMI-ANNUAL REPORT TO CONGRESS IN FEBRUARY. TO THE INTEREST-RATE WATCHERS, HE SAID THAT THE FED "RECOGNIZED THE DESIRABILITY OF ACHIEVING AND MAINTAINING A LOWER LEVEL OF INTEREST RATES TO ENCOURAGE GROWTH, BUT FELT THAT THIS COULD ONLY BE REALISTIC IN A CONTEXT OF BUILDING ON THE PROGRESS ALREADY MADE AGAINST INFLATION." HE ADDED THAT ANY EFFORT TO FORCE INTEREST RATES DOWN THROUGH EXCESSIVE LIQUIDITY CREATION COULDN'T BE SUCCESSFUL FOR LONG BECAUSE AGGRESSIVE EFFORTS TO EASE MONETARY POLICY WOULD GENERATE NEW FEARS OF FUTURE INFLATION.

AT THE SAME TIME, I WOULD REMIND THE MONEY-GROWTH WATCHERS THAT THERE WERE GOOD REASONS WHY THE NARROW (M-1) MONEY SUPPLY -- CURRENCY PLUS CHECK-TYPE DEPOSITS -- GREW ABOVE TARGET LAST YEAR. THE FED PERMITTED ABOVE-TARGET GROWTH BECAUSE OF ITS CONVICTION THAT, IN PRACTICAL TERMS, POLICY OTHERWISE WOULD HAVE BEEN APPRECIABLY MORE RESTRICTIVE THAN INTENDED WHEN THE TARGETS WERE SET IN EARLY 1982.

LET ME EXPLAIN THIS IN A LITTLE MORE DETAIL BECAUSE IT GOES TO THE HEART OF THE NEED FOR AN INDEPENDENT CENTRAL BANK. IN 1982 THERE WAS A SIGNIFICANT INCREASE IN THE PUBLIC'S DESIRE TO HOLD (RATHER THAN TO SPEND) LARGER MONEY BALANCES. THERE IS SOME DEBATE AMONG ECONOMISTS AS TO WHY THIS OCCURRED. SOME WOULD ARGUE THAT THE INCREASED UNCERTAINTIES ASSOCIATED WITH HISTORIC HIGH UNEMPLOYMENT INCREASED THE PRECAUTIONARY BALANCES THAT PEOPLE WISH TO HOLD. OTHERS WOULD ARGUE THAT THE DECLINE IN THE INTEREST RATE HAS MADE IT MORE ATTRACTIVE TO HOLD MONEY RELATIVE TO OTHER ASSETS THAN IN THE PAST. IN ANY EVENT, THE PUBLIC'S DESIRE TO HOLD M-1 INCREASED DRAMATICALLY IN 1982. AS A RESULT, THE RATIO OF INCOME TO MONEY -- IN OTHER WORDS, THE VELOCITY OF MONEY -- FELL SIGNIFICANTLY IN 1982. WITH THE SAME AMOUNT OF MONEY DOING LESS WORK

THAN BEFORE, THE FEDERAL RESERVE HAD TO SUPPLY MORE DURING 1982 THAN IT ORIGINALLY INTENDED IN ORDER TO AVOID BEING MORE RESTRICTIVE THAN WAS DESIRABLE OR NECESSARY. THUS, RATHER THAN FORCE M-1 TO GROW IN THE ORIGINALLY-SPECIFIED RANGE OF $2\frac{1}{2}$ TO $5\frac{1}{2}$ PERCENT, THE FED ALLOWED IT TO GROW $8\frac{1}{2}$ PERCENT IN 1982. THE DECISION TO DO THIS WAS A JUDGEMENT CALL WHICH HAS BEEN RATIFIED BY THE VERY POSITIVE RESPONSE OF THE FINANCIAL MARKETS AS SHOWN IN A DECLINE IN LONG-TERM INTEREST RATES AND A RISE IN STOCK PRICES. IN MY JUDGMENT, FORCING M-1 TO STAY WITHIN THE ORIGINAL $2\frac{1}{2}$ TO $5\frac{1}{2}$ PERCENT RANGE IN 1982 WOULD HAVE BEEN FAR TOO RESTRICTIVE AND RISKED DOING DAMAGE TO AN ALREADY WEAKENED ECONOMY.

CASE FOR FED INDEPENDENCE

THIS EXAMPLE SUGGESTS THAT A STRONG DOSE OF POLICY PRAGMATISM IS CALLED FOR IN THESE UNCERTAIN TIMES. IN FACT, MONETARY POLICY IS NOT ONLY AIMED AT PROVIDING ENOUGH MONEY AND CREDIT TO FACILITATE RECOVERY IN ORDER TO ASSURE THAT THE RECOVERY IS SUSTAINABLE, BUT ALSO RECOGNIZES THE NECESSITY OF CONTINUING THE PROGRESS AGAINST INFLATION. THIS MEANS WALKING A VERY NARROW LINE, ONE WHICH RECOGNIZES THAT A NONINFLATIONARY RECOVERY COULD BE ENDANGERED BY EITHER RIGID INTEREST-RATE TARGETING OR RIGID MONEY-GROWTH TARGETING.

IT IS PRECISELY SITUATIONS LIKE THIS THAT UNDERSCORE THE CASE FOR A STRONG AND INDEPENDENT CENTRAL BANK WITHIN, BUT NOT OF, THE FEDERAL GOVERNMENT. THE TECHNICAL COMPLEXITIES OF ADJUSTING THE NATION'S MONETARY AND CREDIT NEEDS TO A FAST-CHANGING FINANCIAL ENVIRONMENT AND PAYMENTS SYSTEM CANNOT BE HANDLED WELL BY A LARGE DELIBERATIVE BODY SUCH AS CONGRESS. WISELY, THEN, CONGRESS DECIDED 70 YEARS AGO TO DELEGATE AUTHORITY OVER THE DAY-TO-DAY CONDUCT OF MONETARY POLICY TO OUR CENTRAL BANK WHILE KEEPING ULTIMATE CONTROL OVER THE FED'S ACTIONS.

CONGRESS ALSO RECOGNIZED THEN, ON THE BASIS OF ABUNDANT HISTORICAL EVIDENCE, THAT CONTROL OVER THE POWER TO CREATE MONEY SHOULD BE KEPT OUT OF THE HANDS OF THOSE WITH THE RESPONSIBILITY OF FASHIONING SPENDING PROGRAMS AND PAYING THE GOVERNMENT'S BILLS. IN A WORD, IT RECOGNIZED THE NEED FOR A CENTRAL BANK INDEPENDENT OF THE ADMINISTRATION WHICH WOULD HAVE A VESTED INTEREST IN FIGHTING INFLATION.

THIS JUDGMENT IS AMPLY SUPPORTED BY A LOOK AT THE EXPERIENCE IN OTHER COUNTRIES. FINANCIAL INSTABILITY AND ENDEMIC INFLATION FREQUENTLY ARE THE FATE OF THOSE COUNTRIES WHOSE CENTRAL BANKS DO NOT ENJOY A SUBSTANTIAL DEGREE OF INDEPENDENCE. IN SUCH COUNTRIES, MONETARY POLICY OFTEN IS MADE SUBSERVIENT TO FISCAL AND DEBT POLICIES, LEAVING THE INEVITABLE AND USUALLY IRRESISTIBLE TEMPTATION TO FINANCE THE BUDGET WITH EXCESSIVE MONEY GROWTH. CONVERSELY, THE COUNTRIES WITH THE BEST RECORDS OF MODERATE MONEY GROWTH AND INFLATION GENERALLY ARE THOSE WHOSE CENTRAL BANKS ENJOY A SUBSTANTIAL DEGREE OF INDEPENDENCE WITHIN THEIR GOVERNMENTS, SUCH AS WEST GERMANY, SWITZERLAND, AND THE UNITED STATES.

DESPITE SUCH EVIDENCE, THERE CURRENTLY ARE A NUMBER OF PROPOSALS WHICH WOULD VASTLY INCREASE THE POTENTIAL FOR "POLITICIZING" THE FED AND REDUCING ITS INDEPENDENCE. SOME PROPOSALS WOULD SUBJECT THE FED TO THE CONGRESSIONAL APPROPRIATIONS PROCESS -- THEREBY REMOVING THE KEY BULWARK OF ITS INSULATION FROM DAY-TO-DAY POLITICAL PRESSURES IN THE CONDUCT OF MONETARY POLICY. OTHERS WOULD EXPAND THE INFLUENCE OF THE EXECUTIVE BRANCH OVER THE FED BY REDUCING THE TERMS OF GOVERNORS FROM 14 TO 7 YEARS, AND BY PLACING THE TREASURY SECRETARY (WHO REPRESENTS THE WORLD'S LARGEST BORROWER) BACK ON THE BOARD OF GOVERNORS. I SAY "BACK" ON THE BOARD BECAUSE THIS WAS A POSITION WHICH HE (AND THE

COMPTROLLER OF THE CURRENCY) HELD UNTIL THEY WERE REMOVED BY THE CONGRESS IN 1935 IN RESPONSE TO CONCERN OVER THE EXCESSIVE INFLUENCE THAT THE TREASURY SECRETARY, AS BOARD CHAIRMAN, HAD EXERTED ON THE FED OVER THE YEARS ON BEHALF OF THE EXECUTIVE BRANCH.

THE EXPERIENCES FROM ABROAD AND FROM OUR HISTORY UNDERSCORE THE NEED FOR CENTRAL BANK INDEPENDENCE. TO MY MIND, IT WOULD BE TRAGIC IF THE FED'S ABILITY TO IMPLEMENT ITS RESPONSIBILITIES, INCLUDING ITS EFFORTS TO PROMOTE A SUSTAINED NON-INFLATIONARY RECOVERY, WERE TO BE COMPROMISED BY THE ADOPTION OF NEAR-SIGHTED PROPOSALS WHICH WOULD REDUCE ITS ABILITY TO CONDUCT MONETARY POLICY FREE FROM DAY-TO-DAY POLITICAL PRESSURES.

CONCLUDING REMARKS

TO SUM UP, WE CAN BE THANKFUL FOR HAVING BROKEN BOTH THE UPWARD SPIRAL OF INFLATION AND THE DOWNWARD SPIRAL OF RECESSION DURING THE PAST YEAR. MUCH REMAINS TO BE DONE, OF COURSE. WE MUST DEAL WITH THE PROBLEM OF LONG-TERM UNEMPLOYMENT IN MANY OF OUR BASIC INDUSTRIES. THIS CAN BEST BE ACCOMPLISHED BY HAVING FINANCIAL MARKETS, PARTICULARLY LONG-TERM CAPITAL MARKETS, WHICH ARE NOT PLAGUED WITH RENEWED FEARS OF FUTURE INFLATION. THERE ARE ALSO A NUMBER OF UNUSUAL INTERNATIONAL PROBLEMS CONFRONTING US AS WE PROCEED INTO THE RECOVERY. THE MOST IMPORTANT OF THESE IS THE SEVERE FINANCIAL DIFFICULTIES SOME DEVELOPING COUNTRIES ARE EXPERIENCING IN SERVICING THEIR HUGE FOREIGN DEBT, A CONSIDERABLE PORTION OF WHICH IS OWED TO U.S. BANKS. IT IS DIFFICULT TO SEE HOW A SUSTAINED RECOVERY IN THE U.S. ECONOMY WILL BE POSSIBLE WITHOUT FURTHER DECLINES IN REAL INTEREST RATES. THE FEDERAL RESERVE'S POLICY OF PROVIDING ENOUGH MONEY TO SUSTAIN A NON-INFLATIONARY RECOVERY

CAN CONTRIBUTE TO SOLVING THESE PROBLEMS, BUT IT CANNOT DO THE JOB ALONE. SUCCESS ON ALL THESE FRONTS WILL BE DIFFICULT -- IN FACT, WILL BE ALMOST IMPOSSIBLE -- IF CONGRESS AND THE ADMINISTRATION FAIL TO CURB THE ENORMOUS BUDGET DEFICITS WHICH THREATEN EITHER TO SHORT-CIRCUIT THE RECOVERY OR TO UNLEASH A NEW ROUND OF INFLATION.