

# THE FEDERAL RESERVE AND THE BUSINESS OUTLOOK

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## INTRODUCTION

THE U.S. ECONOMY WENT THROUGH SOME PRETTY WRENCHING TIMES IN THE LAST FEW YEARS, BUT ALL SIGNS THUS FAR IN 1983 INDICATE THAT WE ARE IN THE MIDST OF A STRONG RECOVERY. WE HAVE ACCOMPLISHED A GREAT DEAL IN CLEARING THE ECONOMIC LANDSCAPE OF ONE OF OUR MOST SERIOUS PROBLEMS -- INFLATION; SPECIFICALLY OUR POLICY ACTIONS HAVE CUT THE RATE OF INFLATION IN HALF SINCE 1981. IN THE PROCESS, WE HAVE ESTABLISHED THE BASE FOR A SUBSTANTIAL BUSINESS RECOVERY. NEVERTHELESS, OUR FUTURE ECONOMIC HEALTH IS VULNERABLE IN SEVERAL AREAS. UNEMPLOYMENT AND FINANCIAL PROBLEMS CONTINUE TO PLAGUE THE U.S. AND WORLD ECONOMIES, FOR EXAMPLE, 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 CONSUMER PRICE INDEX AND THE WHOLESALE PRICE INDEX FOR FINISHED GOODS 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 EIGHT MONTHS OF THIS YEAR THE CPI ROSE AT A 4.1 PERCENT ANNUAL RATE, WHILE THE WHOLESALE PRICE INDEX HAS ACTUALLY FALLEN AT AN ANNUAL RATE OF NEARLY ONE PERCENT FROM DECEMBER TO AUGUST.

AS THE INFLATION NUMBERS CONTINUE TO BRING GOOD NEWS, ATTENTION

IS BEING INCREASINGLY FOCUSED ON THE ECONOMY'S ABILITY TO SUSTAIN THE ECONOMIC EXPANSION THAT BEGAN AT THE END OF LAST YEAR. THE INDEX OF LEADING ECONOMIC INDICATORS HAS BEEN MOVING UPWARD SINCE SEPTEMBER 1982, AND SINCE JANUARY HAS SCORED A VERY IMPRESSIVE GAIN OF 9.0 PERCENT. BUTTRESSING THAT EVIDENCE, REAL GNP GROWTH AT 9.7 PERCENT IN THE SECOND QUARTER OF THIS YEAR IS THE STRONGEST IT HAS BEEN IN OVER TWO YEARS, AND ESTIMATES FOR THE THIRD QUARTER INDICATE GNP CONTINUES TO EXPAND AT A HEALTHY 7.9 PERCENT RATE. ALSO, THE UNEMPLOYMENT RATE HAS DROPPED OUT OF DOUBLE-DIGIT TERRITORY TO 9.3 PERCENT IN SEPTEMBER, AS EMPLOYMENT INCREASED BY ALMOST 2½ MILLION BETWEEN MAY AND SEPTEMBER.

THE SCATTERED SIGNS OF WEAKNESS THAT SHOWED UP IN AUGUST APPEAR TO BE DISAPPEARING AS THE SEPTEMBER NUMBERS COME IN. THUS THE FALL-OFF IN AUGUST AUTO SALES REVERSED ITSELF IN SEPTEMBER, SUGGESTING THAT THE AUGUST WEAKNESS WAS CAUSED BY DEALER SHORTAGES OF CARS RATHER THAN ANY RELUCTANCE ON THE PART OF THE AMERICAN CAR-BUYING PUBLIC. SIMILARLY, PERSONAL INCOME GROWTH BEGAN TO PICK UP STEAM AGAIN IN SEPTEMBER LEADING MANY OBSERVERS TO ATTRIBUTE THE AUGUST SLOW-DOWN IN THIS KEY STATISTIC TO THE TELEPHONE WORKERS STRIKE. AND AS INCOMES HAVE REBOUNDED, SO HAVE RETAIL SALES, WHICH GREW 1.5 PERCENT IN SEPTEMBER AFTER FALLING 1.6 PERCENT IN AUGUST.

THUS IT SEEMS CLEAR THAT THE CURRENT ECONOMIC EXPANSION IS CONTINUING. THE IMPORTANT QUESTION AT THIS POINT, HOWEVER, IS WHAT POTENTIAL PROBLEMS MIGHT LIE AHEAD. TO MY MIND, THERE ARE THREE. FIRST, IS THERE A RISK OF INFLATION RE-ACCELERATING AS THE ECONOMY

CONTINUES TO EXPAND? SECOND, DO HIGH INTEREST RATES RAISE THE POSSIBILITY OF RECESSION NEXT YEAR? AND THIRD, DOES THE PROSPECT OF LARGE GOVERNMENT DEFICITS THREATEN TO DISTORT THE RECOVERY? I WILL RETURN TO THESE POINTS AFTER DISCUSSING WHAT I THINK ARE THE MOST LIKELY OUTLOOKS FOR THE U.S. AND HAWAIIAN ECONOMIES.

#### 1983 AND 1984 OUTLOOK FOR NATION

AT OUR BANK, WE EXPECT REAL GNP FOR THE U.S. AS A WHOLE COULD GROW CLOSE TO 6.0 PERCENT DURING 1983 AND SHOULD CONTINUE TO EXPAND AT ABOUT 5.0 PERCENT IN 1984. PLANT AND EQUIPMENT SPENDING WILL GROW ONLY MODESTLY IN 1983 (ON A FOURTH QUARTER OVER FOURTH QUARTER BASIS), BECAUSE OF THE CURRENT HIGH LEVELS OF EXCESS PLANT CAPACITY; AND WE EXPECT NET EXPORTS TO DECLINE, OWING TO A STRONG EXCHANGE VALUE OF THE DOLLAR. IN CONTRAST, CONSUMER SPENDING HAS BEEN THE REAL LEADER IN PROMOTING AND SUSTAINING THE CURRENT RECOVERY. ITS STRENGTH REFLECTS THE SUBSTANTIAL IMPROVEMENT IN REAL CONSUMER INCOMES AND WEALTH, AS INFLATION SLOWED DRAMATICALLY, LAST JULY'S TAX CUTS TOOK EFFECT, AND THE SPARKLING STOCK MARKET RALLY BOOSTED THE VALUE OF HOUSEHOLD'S PORTFOLIOS.

CONSUMER SPENDING GREW AT A ROBUST 6.4 PERCENT IN THE FIRST HALF OF 1983 AND WE EXPECT THIS GROWTH TO CONTINUE, ALTHOUGH AT THE SLOWER RATE OF 3.5 PERCENT, OVER THE LAST HALF OF 1983 AND 1984.

SIMILARLY, THE SURGE IN INVENTORY INVESTMENT WE HAVE EXPERIENCED RECENTLY WILL NOT CONTINUE TO PROVIDE THE SAME SPUR TO THE GROWTH OF OUTPUT AND EMPLOYMENT IN 1984 THAT IT DID THIS YEAR. AT THE END OF 1982 BUSINESSES WERE RUNNING OFF INVENTORIES AND DEPRESSING REAL GNP

GROWTH. BUT BY THE THIRD QUARTER OF 1983, THEY WERE ESTIMATED TO BE ADDING TO THEIR INVENTORIES AND THEREBY, RAISING REAL GNP GROWTH. THIS TURN-AROUND IS ESTIMATED TO HAVE ACCOUNTED FOR NEARLY HALF OF THE GROWTH OF REAL GNP SINCE THE RECOVERY BEGAN. IN 1984, HOWEVER, INVENTORY INVESTMENT WILL NOT GROW BY NEARLY AS MUCH, SIMPLY BECAUSE INVENTORY-SALES RATIOS ARE NOW REASONABLY COMFORTABLE.

DESPITE MORE MODERATE GROWTH IN PERSONAL CONSUMPTION EXPENDITURES AND INVENTORY ACCUMULATION, WE EXPECT THE OVERALL GROWTH OF THE ECONOMY IN 1984 TO BE NEARLY AS STRONG AS IN 1983. BUSINESS SPENDING ON PLANT AND EQUIPMENT, SPENDING BY THE FEDERAL GOVERNMENT, AND A MODEST REBOUND IN NET EXPORTS ARE LIKELY TO LEAD THE WAY. ALTHOUGH THE RATE OF CAPACITY UTILIZATION IS STILL RELATIVELY LOW, BUSINESS EXPENDITURES TO INSTALL MORE EFFICIENT AND MODERN EQUIPMENT ARE ALREADY QUITE STRONG, PARTLY AS A CONSEQUENCE OF THE TAX INCENTIVES IN THE ECONOMIC RECOVERY TAX ACT OF 1981. ALSO, AS THE ECONOMIC RECOVERY GAINS MOMENTUM ABROAD, OUR FOREIGN TRADE PICTURE SHOULD IMPROVE SOMEWHAT, EVEN THOUGH THE GAINS WILL BE LIMITED BY THE CONTINUED STRENGTH IN THE INTERNATIONAL VALUE OF THE DOLLAR. ALL IN ALL, WE CAN EXPECT THE CONTINUATION OF SOLID GROWTH FOR THE REST OF THE YEAR AND NEXT YEAR, BUT CERTAINLY NO BOOM.

#### HAWAII SCENE

LET ME TURN NEXT TO THE HAWAII SCENE. IN RECENT MONTHS, THE HAWAIIAN ECONOMY HAS BEGUN TO SHOW THE FIRST GLIMMERINGS OF RECOVERY FROM THE MILD RECESSION THAT BEGAN LAST YEAR AND THAT EXTENDED INTO THE FIRST HALF OF 1983. I SAY A MILD RECESSION BECAUSE HAWAII'S

ECONOMY HAS REALLY ONLY PAUSED IN GROWTH COMPARED WITH THE SEVERE DOWNTURN EXPERIENCED NATIONALLY. IN AUGUST, FOR EXAMPLE, THE HAWAIIAN UNEMPLOYMENT RATE WAS 6.7 PERCENT ON A SEASONALLY ADJUSTED BASIS --THE LOWEST IN THE NATION.

AS YOU ARE AWARE OF HAWAII'S TRADITIONAL STRENGTHS, I WILL ONLY TOUCH ON THE FACTORS THAT HAVE PROMOTED THE TURNAROUND: THE RISE IN PERSONAL INCOME ON THE MAINLAND HAS SPURRED TOURISM; THE DROP IN MORTGAGE INTEREST RATES HAS STIMULATED HOMEBUILDING AND SALES; AND THE INCREASE IN DEFENSE SPENDING SHOULD BENEFIT BOTH CIVILIAN AND MILITARY PAYROLLS.

THE TURNAROUND IN THE HAWAIIAN ECONOMY DURING THE LATTER HALF OF 1983 IS LIKELY TO SET THE STAGE FOR MORE SOLID GROWTH IN 1984. AS THE NATIONAL ECONOMY CONTINUES TO GROW AND WORLD ECONOMIC CONDITIONS IMPROVE, TOURIST BUSINESS SHOULD IMPROVE EVEN MORE THAN IT HAS THIS YEAR. THE INCREASE IN RESIDENTIAL BUILDING PERMITS ISSUED THIS YEAR, ALONG WITH THE REDUCTION IN UNSOLD UNITS, SUGGESTS THAT HOUSING STARTS AND SALES ALSO COULD INCREASE BY A GREATER PERCENTAGE NEXT YEAR -- PROVIDED INFLATION AND INTEREST RATES CAN BE KEPT UNDER CONTROL. SIMILARLY, AS THE RECOVERY REDUCES VACANCY RATES, EXPENDITURES FOR NON-RESIDENTIAL CONSTRUCTION -- WHICH HAS REMAINED A WEAK SPOT IN HAWAII --SHOULD AT LEAST STABILIZE. FINALLY, SUGAR AND PINEAPPLE GROWERS, WHO HAVE SUFFERED FROM A WORLD-WIDE GLUT OF THEIR PRODUCTS, SHOULD FACE IMPROVED MARKET CONDITIONS AS EXPANDING WORLDWIDE DEMAND BRINGS SUPPLY AND DEMAND INTO BETTER BALANCE.

## INFLATION RISK

DESPITE ALL THE PLUS SIGNS IN THE OUTLOOK, SERIOUS CONCERNS REMAIN, AS I MENTIONED EARLIER. THERE IS THE CONCERN WHETHER INFLATION WILL PICK UP IN 1984. TYPICALLY, INFLATION DOES NOT BEGIN TO RISE UNTIL AT LEAST A YEAR AFTER A BUSINESS CYCLE UPTURN. WITH THE RECOVERY NEARLY A YEAR OLD THIS WOULD ARGUE FOR A REBOUND IN INFLATION NEXT YEAR. THE STANDARD EXPLANATION FOR THE CYCLICAL UPTURN IN INFLATION POINTS TO EXPANSIONARY MACROECONOMIC POLICY AS THE FUNDAMENTAL CAUSE. THUS A MORE STIMULATORY POLICY FIRST INCREASES OUTPUT AND EMPLOYMENT, AND THEN SHOWS UP LATER -- WITH A LAG IN OTHER WORDS -- IN HIGHER PRICES.

WITH THIS BACKGROUND IN MIND, SOME COMMENTATORS HAVE ARGUED THAT THE FED HAS ALREADY LET THE INFLATIONARY CAT OUT OF THE BAG. THUS FOR THE TWELVE MONTHS ENDING AUGUST OF 1983, THE M1 DEFINITION OF THE MONEY SUPPLY, WHICH IS COMPOSED OF CURRENCY AND ALL CHECKABLE DEPOSITS, GREW AT A 12.7 ANNUAL RATE, THE HIGHEST SUSTAINED MONETARY EXPANSION SINCE WORLD WAR II. THE CRITICAL QUESTION IS WHETHER THIS FORETELLS A DRAMATIC RISE IN INFLATION SOMETIME IN THE FUTURE.

IN MY OPINION IT DOES NOT, BECAUSE MUCH OF THE OBSERVED HIGH MONEY GROWTH, AT LEAST IN LATE 1982 AND THE FIRST PART OF 1983, WAS MATCHED BY AN INCREASE IN MONEY DEMAND.

LET ME EXPLAIN THIS POINT IN A LITTLE MORE DETAIL BECAUSE I THINK IT IS NOT WIDELY UNDERSTOOD OR PROPERLY APPRECIATED. 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 WISHED TO HOLD. OTHERS WOULD ARGUE THAT THE DECLINE IN INTEREST RATES HAS MADE IT MORE ATTRACTIVE TO HOLD MONEY RELATIVE TO OTHER ASSETS -- A VIEW WHICH I AND MY STAFF HAVE ARGUED STRONGLY FOR. IN ANY EVENT, THE PUBLIC'S DESIRE TO HOLD M1 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 M1 TO GROW IN THE ORIGINALLY-SPECIFIED RANGE OF 2½ TO 5 PERCENT, THE FED ALLOWED IT TO GROW 8½ PERCENT IN 1982. THE DECISION TO DO THIS WAS A JUDGMENT CALL THAT WAS RATIFIED BY THE VERY POSITIVE RESPONSE OF THE FINANCIAL MARKETS AS SHOWN BY THE DECLINE IN LONG-TERM INTEREST RATES AND THE RISE IN STOCK PRICES IN THE LATTER HALF OF 1982. IN MY JUDGMENT, FORCING M1 TO STAY WITHIN THE ORIGINAL 2½ TO 5½ PERCENT RANGE IN 1982 WOULD HAVE RISKED DOING DAMAGE TO AN ALREADY WEAKENED ECONOMY AND PRECLUDED THE ECONOMIC RECOVERY WHICH BEGAN AT THE TURN OF THIS YEAR.

IT IS IMPORTANT TO UNDERSTAND THAT THIS DOWNWARD ADJUSTMENT OF VELOCITY TO THE LOWER INFLATION RATE IS A ONE-TIME PHENOMENON. ONCE THE ADJUSTMENT IS COMPLETE, MONEY GROWTH SHOULD BE MADE TO RETURN TO RATES THAT ALLOW US TO CONTINUE TO MAKE PROGRESS AGAINST INFLATION. AS CHAIRMAN VOLCKER NOTED IN HIS MIDYEAR MONETARY POLICY REPORT TO THE



CONGRESS IN JULY, THE DECLINE IN VELOCITY APPEARED TO HAVE LARGELY ABATED BY THE END OF THE FIRST QUARTER OF 1983, SUGGESTING THAT THE ADJUSTMENT OF MONEY DEMAND TO LOWER INFLATION WAS MORE OR LESS COMPLETE BY THEN. IN RECOGNITION OF THIS, THE FOMC DECIDED TO ESTABLISH A NEW BASE FOR THE M1 GROWTH RANGE, MOVING IT FROM THE FOURTH QUARTER OF 1982 TO THE SECOND QUARTER OF 1983. AS CHAIRMAN VOLCKER NOTED, THIS REBENCHMARKING "REFLECTED A JUDGMENT THAT THE RAPID GROWTH (IN M1) OVER THE PAST SEVERAL QUARTERS SHOULD BE TREATED AS A ONE-TIME PHENOMENON, NEITHER TO BE RETRACED OR LONG EXTENDED."

EARLIER THIS YEAR, I HAD ARGUED THAT IF MONEY GROWTH DID NOT APPEAR TO BE SLOWING DOWN AFTER THE FIRST QUARTER, THE FEDERAL RESERVE SHOULD TAKE STEPS TO ASSURE THAT IT DID, EVEN IF THAT MEANT SOME MODERATE INCREASE IN INTEREST RATES. BY THE LATTER PART OF THE SECOND QUARTER, MONEY AND CREDIT WERE SHOWING TENDENCIES TO INCREASE MORE RAPIDLY THAN SEEMED CONSISTENT WITH LONG-TERM PROGRESS AGAINST INFLATION AND SUSTAINED ORDERLY RECOVERY. AGAINST THIS BACKGROUND, THE FOMC IN MAY BEGAN TO TAKE A LESS ACCOMMODATING MONETARY POSTURE. THESE STEPS WERE ACCOMPANIED BY INTEREST RATE INCREASES RANGING FROM 3/4 TO 1 PERCENT OR MORE. BUT AS I HAD ARGUED EARLIER, THE PROSPECTS FOR SUSTAINED GROWTH AND ULTIMATELY LOWER INTEREST RATES OVER TIME WOULD BE ENHANCED BY TIMELY ACTION TO RESTRAIN EXCESSIVE GROWTH IN MONEY, GIVEN ITS INFLATIONARY POTENTIAL.

THE EVENTS OF THE PAST FEW MONTHS, TO MY MIND, HAVE ONLY SERVED TO CONFIRM THIS JUDGMENT. SINCE MARCH, M1 GROWTH HAS AVERAGED 7.1 PERCENT AT AN ANNUAL RATE, COMPARED TO A 14.9 PERCENT RATE IN THE SIX

MONTHS PRECEDING. AS A RESULT, FOR THE FIRST TIME SINCE 1981, M1 FELL WITHIN ITS LONGER-RUN MONITORING RANGE SET BY THE FOMC. THE OTHER KEY MONETARY AGGREGATES ARE ALSO WITHIN THE FEDERAL RESERVE'S TARGET RANGES. M2 WAS GROWING AT AN ANNUAL RATE OF 7.6 PERCENT IN SEPTEMBER (COMPARED TO ITS BASE--THE M2 AVERAGE IN FEBRUARY AND MARCH OF 1983), WELL WITHIN ITS TARGET RANGE OF 7-10 PERCENT. LIKewise, M3 FELL WITHIN ITS RANGE OF 6.5-9.5 PERCENT WHEN IT INCREASED AT THE ANNUAL RATE OF 9.0 PERCENT LAST MONTH (COMPARED TO ITS BASE IN THE SECOND QUARTER OF 1983).

FINANCIAL MARKETS APPEAR TO HAVE BEEN HEARTENED BY THESE DEVELOPMENTS. SINCE AUGUST, SHORT-TERM INTEREST RATES HAVE TENDED TO FALL AS THE MARKET PERCEIVES THAT THE FEDERAL RESERVE HAS MORE ROOM TO MANEUVER WITH MONEY NOW ON TARGET. AT THE SAME TIME, HEIGHTENED INVESTOR CONFIDENCE THAT THE FED WILL NOT GIVE UP ON THE FIGHT AGAINST INFLATION HAS PULLED DOWN LONG-TERM YIELDS AS WELL. LET ME NOTE HERE THAT IT REMAINS THE INTENTION OF THE FEDERAL RESERVE TO MAKE FURTHER INROADS AGAINST INFLATION. CHAIRMAN VOLCKER MADE THIS VERY CLEAR IN HIS SPEECH TO THE AMERICAN BANKERS ASSOCIATION HERE IN HONOLULU A COUPLE OF WEEKS AGO, AND I CAN ONLY REAFFIRM OUR COMMITMENT TO THIS GOAL.

#### HIGH INTEREST RATE SYNDROME

DESPITE RECENT DECLINES IN NOMINAL, OR MARKET, INTEREST RATES, YIELDS IN A VERY IMPORTANT SENSE REMAIN DISTURBINGLY HIGH. I REFER TO REAL INTEREST RATES -- INTEREST RATES WITH THE MARKET PREMIUM FOR INFLATION TAKEN OUT OF THEM. THESE REAL RATES MEASURE THE TRUE

BORROWING COST FOR HOUSEHOLDS AND FIRMS, AND THEY REMAIN HIGH BY HISTORICAL STANDARDS, ESPECIALLY FOR THIS STAGE OF THE BUSINESS CYCLE.

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. THE RECENT INCREASE IN THE DOLLAR EXCHANGE RATE, FOR EXAMPLE, HAS PUSHED THE DOLLAR'S INTERNATIONAL VALUE ABOVE THE RECORD LEVEL OF NOVEMBER 1982. AN OVER-VALUED DOLLAR MEANS THAT IMPORTS ARE ENCOURAGED AND EXPORTS DISCOURAGED -- WHICH IN TURN MEANS CONTINUED DISTRESS FOR SUCH BASIC INDUSTRIES AS STEEL, AUTOS, AND OF COURSE TOURISM. THUS, THE U.S. TRADE SURPLUS ON GOODS AND SERVICES FOR THE FIRST HALF OF THIS YEAR HAS DROPPED TO \$4.3 BILLION FROM \$31.6 BILLION IN THE SAME PERIOD LAST YEAR.

NOR ARE THE EFFECTS OF AN OVER-VALUED DOLLAR CONFINED TO THE U.S. THE CORRESPONDING DETERIORATION IN THE EXCHANGE VALUE OF FOREIGN CURRENCIES MEANS HIGHER INFLATION FOR THESE COUNTRIES AS THEY FIND THE COST OF THEIR IMPORTS GOING UP. THE ALTERNATIVE FOR THESE COUNTRIES IS TO PROTECT THEIR CURRENCIES BY KEEPING THEIR REAL INTEREST RATES HIGH. BUT THAT MEANS DEPRESSED OUTPUT AND EMPLOYMENT FOR THEM AT HOME, HARDLY AN ATTRACTIVE ALTERNATIVE.

THERE HAS BEEN A GREAT DEAL OF EDITORIAL COMMENT RECENTLY ABOUT WHETHER THOSE HIGH REAL RATES RISK A RECESSION IN 1984. AT THE FEDERAL RESERVE BANK OF SAN FRANCISCO, WE HAVE ALWAYS CAUTIONED THAT HIGH INTEREST RATES BY THEMSELVES DO NOT FORECAST A RECESSION. THEY COULD JUST AS WELL REFLECT A STRONG ECONOMY RATHER THAN A WEAK ONE.

THAT IS, IF A STRONG ECONOMY INCREASES THE DEMAND FOR CREDIT, LEADING TO HIGH INTEREST RATES, THAT WILL NOT BY ITSELF SHORT-CIRCUIT THE RECOVERY. ONLY IF THE HIGH INTEREST RATES ARE DUE TO A SHORTAGE OF THE SUPPLY OF CREDIT WOULD THEY INDICATE THAT THE RECOVERY MIGHT BE IN TROUBLE. WE DO NOT BELIEVE THAT THIS IS WHAT IS HAPPENING IN THE SECOND HALF OF 1983.

THERE ARE A NUMBER OF REASONS FOR OUR HOLDING THIS POSITION. FIRST, THE HIGH LEVELS OF REAL INTEREST RATES WE'VE HAD FOR THE LAST YEAR HAVE NOT PREVENTED A TYPICAL BUSINESS CYCLE EXPANSION FROM OCCURRING. THAT SUGGESTS THAT THE HIGH RATES ARE DUE MORE TO AN INCREASE IN DEMAND FOR CREDIT THAN TO A RESTRICTION IN SUPPLY. SECOND, ONE DOES NOT HAVE TO LOOK VERY FAR FOR ONE OBVIOUS SOURCE OF STRONG CREDIT DEMAND -- THE FEDERAL GOVERNMENT'S NEED TO FINANCE ITS MASSIVE DEFICITS. THUS THE TREASURY WAS IN THE MARKET FOR ABOUT \$44 BILLION IN THE THIRD QUARTER, AND FOURTH QUARTER FINANCIAL REQUIREMENTS ARE EXPECTED TO BE \$45 BILLION. FOR 1983 AS A WHOLE, THE UNIFIED BUDGET DEFICIT CURRENTLY IS PROJECTED TO BE \$207 BILLION AND ONLY SLIGHTLY LOWER -- \$183 BILLION -- IN 1984. FINALLY, THE TOTAL SUPPLY OF CREDIT HAS INCREASED SUBSTANTIALLY IN THE UNITED STATES IN THE LAST YEAR, FROM ABOUT 11 PERCENT OF GNP IN MID-1982 TO 13 PERCENT IN MID-1983. ON BALANCE, THEREFORE, IT WOULD SEEM HIGH REAL INTEREST RATES REFLECT STRONG CREDIT DEMAND, NOT WEAK CREDIT SUPPLY.

#### DEFICITS AND ECONOMIC DISTORTIONS

AS I OUTLINED EARLIER, THE CURRENT BUSINESS CYCLE EXPANSION IS LED BY A LARGE INCREASE IN CONSUMER SPENDING, FOLLOWED BY A SMALL

INCREASE IN INVESTMENT SPENDING, AND A DECLINE IN NET EXPORTS. THIS REPRESENTS A DISTORTED BUSINESS CYCLE SITUATION COMPARED TO THE TYPICAL RECOVERY OF THE PAST, IN WHICH THERE WAS A MUCH MORE BALANCED GROWTH OF CONSUMPTION, INVESTMENT AND EXPORTS. CONCERNS THAT THE CURRENT DISTORTED PATTERN WILL HURT THE ECONOMY ARE, IN MY OPINION, WELL TAKEN.

THIS RECOVERY IS JUST THE OPPOSITE OF THE SUPPLY-SIDE ECONOMISTS' EXPECTATIONS THAT TAX CUTS WOULD LEAD TO AN INVESTMENT-LED RECOVERY. HIGH REAL INTEREST RATES HAVE MORE THAN OFFSET THE STIMULUS OF LOWER TAXES ON BUSINESS INVESTMENT. THE REASON FOR THIS DISTORTION IS QUITE EASY TO SEE. SINCE THE START OF 1981, GOVERNMENT SPENDING AS A SHARE OF GNP HAS GONE UP 2 PERCENTAGE POINTS -- FROM 23 TO 25 PERCENT OF GNP. THAT ADDITIONAL ABSORPTION OF RESOURCES BY GOVERNMENT MEANS THAT PRIVATE DEMANDS MUST BE REDUCED AN EQUAL AMOUNT. IN OTHER WORDS, SOME FORM OF PRIVATE SPENDING HAS TO BE "CROWDED OUT" BY THE INCREASED DEMANDS OF GOVERNMENT. THAT CAN BE ACHIEVED IN THREE DIFFERENT WAYS -- BY RAISING TAX RATES, BY INCREASING THE INFLATION RATE, OR BY RAISING REAL INTEREST RATES. A RISE IN TAXES WOULD CROWD OUT THE SPENDING OF THOSE WHO BEAR THE BURDEN OF THE TAX. A RISE IN THE INFLATION RATE WOULD CROWD OUT THOSE WHOSE INCOME GROWS MORE SLOWLY THAN INFLATION. AND A RISE IN REAL INTEREST RATES WOULD CROWD OUT THE INTEREST-SENSITIVE SPENDING, WHICH IS LARGELY FOCUSED ON INVESTMENT, HOUSING AND EXPORTS.

THE ADMINISTRATION APPEARS ADAMANTLY OPPOSED TO TAX HIKES, AND IN ANY EVENT IT IS UNLIKELY CONGRESS WILL BE IN THE MOOD TO RAISE TAXES

AS THE 1984 ELECTION NEARS. AS I INDICATED EARLIER, THE FEDERAL RESERVE REMAINS RESOLUTE IN ITS DETERMINATION TO CUT INFLATION FURTHER, AND AS CHAIRMAN VOLCKER INDICATED IN RECENT TESTIMONY TO CONGRESS, BELIEVES IT IS UNWISE TO FINANCE BUDGET DEFICITS THROUGH MONETARY EXPANSION. ALL OF THIS MEANS THAT HIGHER GOVERNMENT SPENDING HAS BEEN FINANCED BY BORROWING IN THE FINANCIAL MARKETS, RESULTING IN A RISE IN REAL INTEREST RATES. AS A RESULT, ALL OF THE CROWDING OUT CAUSED BY INCREASED GOVERNMENT SPENDING HAS BEEN DIRECTED ONTO INTEREST-SENSITIVE AND EXPORT-SENSITIVE INDUSTRIES, WHICH REPRESENT OUR INDUSTRIES WITH THE GREATEST COMPARATIVE ADVANTAGE, AND OUR FUTURE SOURCES OF GROWTH. THE DISTORTED RECOVERY THEREFORE THREATENS THE GROWTH IN THE STANDARD OF LIVING AND THE PRODUCTIVITY OF THE U.S. ECONOMY. IN MY OPINION, THAT IS THE MAJOR RISK IN THE CURRENT SITUATION --NOT AN ACCELERATION OF INFLATION, OR A BUSINESS CYCLE RECESSION IN 1984, BUT THE LONG, SLOW EROSION OF AMERICA'S INDUSTRIAL BASE.

#### ECONOMIC EDUCATION

THE CROWDING-OUT PHENOMENON I HAVE JUST DESCRIBED IS A PERFECT ILLUSTRATION OF TWO FUNDAMENTAL ECONOMIC CONCEPTS IN OPERATION -- THE CONCEPTS OF TRADEOFF AND CHOICE. AS ECONOMIC EDUCATORS, I KNOW YOU ARE COMPLETELY FAMILIAR WITH THESE CONCEPTS; INDEED I KNOW THAT THEY PLAY A FUNDAMENTAL ROLE IN THE JOINT COUNCIL'S EDUCATIONAL STRATEGY, AND HAVE BEEN THE BASIS OF A VERY SUCCESSFUL FILM/TELEVISION SERIES CALLED "TRADE-OFFS".

THESE KEY CONCEPTS OF TRADEOFF AND CHOICE ARE ALSO MAJOR THEMES

IN THE FEDERAL RESERVE BANK'S VENTURE INTO ECONOMIC EDUCATION, A PERMANENT EDUCATIONAL EXHIBITION CALLED "THE WORLD OF ECONOMICS" THAT IS LOCATED IN THE LOBBY OF OUR NEW HEADQUARTERS BUILDING IN DOWNTOWN SAN FRANCISCO. SOME OF YOU MAY HAVE SEEN IT ALREADY, AND I EXTEND AN INVITATION TO THE REST OF YOU TO VISIT IT IF YOU GET THE CHANCE. OF COURSE, I APPRECIATE THAT INVITING YOU TO VISIT US IS NOT LIKE ASKING YOU TO STEP ACROSS THE STREET, SO WE HAVE MADE AVAILABLE A TEN-MINUTE VIDEOTAPE ON THE EXHIBITION, WHICH WILL GIVE YOU SOME SENSE OF WHAT THE EXHIBITION IS, AND WHAT IT CAN DO. OUR PUBLIC INFORMATION DEPARTMENT WOULD BE HAPPY TO LEND YOU A COPY OF THE TAPE, IF YOU'RE INTERESTED.

WE WERE VERY FORTUNATE TO HAVE THE JOINT COUNCIL'S COOPERATION AND SUPPORT AS WE WERE BUILDING THE EXHIBITION, WHICH HELPED US TO AVOID THE PITFALLS THAT SO MANY ORGANIZATIONS FALL INTO WHEN THEY VENTURE INTO ECONOMIC EDUCATION. I'M SURE THAT YOU'RE ALL FAMILIAR WITH THE WALL STREET JOURNAL PIECE OF SEPTEMBER 15, CALLED "WHAT TO DO (AND NOT TO DO) WHEN JOHNNY CAN'T DEFINE PROFIT", BY JOHN MANZER, THE HEAD OF ONE OF YOUR CENTERS FOR ECONOMIC EDUCATION IN INDIANA. AS I READ THROUGH PROFESSOR MANZER'S LIST OF DO'S AND DON'TS FOR ECONOMIC EDUCATION, I WAS REMINDED AGAIN OF HOW LUCKY WE WERE TO HAVE THE JOINT COUNCIL'S INPUT. PARTICULARLY INDISPENSABLE WERE THE CONTRIBUTIONS OF LEE BACH, OF STANFORD UNIVERSITY, AND MY OLD FRIEND AND FACULTY COLLEAGUE JIM CALDERWOOD, WHO IS WITH US TODAY. IT IS NOT TOO FAR-FETCHED TO SAY THAT WITHOUT THE DEDICATION OF PEOPLE LIKE LEE AND JIM -- AND I'M SORRY WE DON'T HAVE TIME TO LIST ALL OF THE PEOPLE WHO

CONTRIBUTED --"THE WORLD OF ECONOMICS" WOULD NOT HAVE TURNED OUT TO BE THE SUCCESS IT HAS PROVEN TO BE.

COOPERATION BETWEEN THE JOINT COUNCIL AND THE RESERVE BANK CONTINUES. THE ECONOMIC LITERACY COUNCIL OF CALIFORNIA HAS WORKED WITH OUR STAFF TO PRODUCE A FULL SET OF CURRICULUM MATERIALS --TEACHER AND STUDENT GUIDES, LESSON PLANS, AND MUCH MUCH MORE -- THAT WILL ALLOW TEACHERS AND STUDENTS TO GET THE MAXIMUM BENEFIT OUT OF THE EXHIBITION. WE WILL BEGIN TESTING THESE MATERIALS IN SAN FRANCISCO SCHOOLS TOWARDS THE END OF THIS YEAR. AT THE SAME TIME, WE ARE HOPING TO PRODUCE A SET OF VIDEOTAPES THAT WILL COMPLEMENT THESE CURRICULUM MATERIALS, THUS IN EFFECT MAKING IT POSSIBLE FOR THE EXHIBITION TO "TRAVEL" TO SCHOOLS THAT ARE TOO FAR AWAY TO VISIT US.

#### CONCLUDING REMARKS

IN SUMMING UP, LET ME RETURN TO THE THEME OF TRADE-OFFS. IN MY MIND, THE MOST SERIOUS PROBLEM CONFRONTING US TODAY IS THE UNBALANCED CHARACTER OF THE CURRENT RECOVERY. THE ROOT OF THIS PROBLEM IS EASY ENOUGH TO TRACE -- THE FEDERAL GOVERNMENT'S VORACIOUS APPETITE FOR CREDIT TO FINANCE ITS DEFICITS. CONGRESS AND THE ADMINISTRATION HAVE IN EFFECT OPTED TO FINANCE THE GROWING SHARE OF GOVERNMENT SPENDING IN TOTAL OUTPUT BY SQUEEZING CAPITAL INVESTMENT, HOUSING AND OUR EXPORT INDUSTRIES. WHAT PARTICULARLY CONCERNS ME IS THAT MUCH OF THE PUBLIC MAY NOT UNDERSTAND THE TRADE OFF THAT IMPLICITLY HAS BEEN MADE HERE. THE BENEFITS OF LOWER TAXES, AND OF GOVERNMENT SPENDING FOR OUR FAVORITE PROGRAMS ARE EASY TO SEE. THE COSTS IN TERMS OF A LOWER STANDARD OF LIVING FOR FUTURE GENERATIONS ARE MUCH MORE DIFFICULT TO