

THE FEDERAL RESERVE
AND THE BUSINESS OUTLOOK

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

MEETING WITH
SALT LAKE CITY
COMMUNITY LEADERS

SALT LAKE CITY, UTAH
NOVEMBER 3, 1983

INTRODUCTION

THE U.S. ECONOMY WENT THROUGH SOME PRETTY WRENCHING TIMES IN THE LAST FEW YEARS. 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 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 HAS GROWN ONLY MODESTLY IN 1983, BECAUSE OF THE CURRENT HIGH LEVELS OF EXCESS PLANT CAPACITY; AND NET EXPORTS HAVE ACTUALLY DECLINED, 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. THIS STRENGTH IN CONSUMER SPENDING 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. WE EXPECT THIS GROWTH TO SLOW TO A 3.5 PERCENT RATE OVER THE LAST HALF OF 1983 AND CONTINUE AT THIS MORE MODERATE PACE IN 1984, AS HOUSEHOLDS TURN THEIR ATTENTION TO RESTORING THEIR SAVINGS PATTERNS TO MORE TRADITIONAL LEVELS. IN THE SECOND QUARTER OF THIS YEAR, THE PERSONAL SAVINGS RATE FELL TO 4 PERCENT, ITS LOWEST LEVEL EVER RECORDED. WE ANTICIPATE HOUSEHOLDS WILL NOW BEGIN TO REBUILD THIS RATIO BY PULLING BACK SOMEWHAT ON THE RATE AT WHICH THEY SPEND.

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, CAUSING REAL GNP GROWTH

TO BE DEPRESSED. IN CONTRAST, BY THE THIRD QUARTER OF 1983, THEY WERE ESTIMATED TO BE ADDING SIGNIFICANTLY TO THEIR INVENTORIES, WHICH TENDED TO RAISE REAL GNP GROWTH. THIS TURN-AROUND IN INVENTORIES IS ESTIMATED TO ACCOUNT 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 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 ECONOMIC RECOVERY GAINS MOMENTUM ABROAD, OUR FOREIGN TRADE PICTURE SHOULD IMPROVE SOMEWHAT, EVEN THOUGH THESE 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.

UTAH SCENE

LET ME TURN NEXT TO THE UTAH SCENE. THE UTAH ECONOMY HAS BEEN SHOWING SIGNS OF MODEST OVERALL IMPROVEMENT SINCE LAST SPRING. CONTINUED LAYOFFS IN THE IMPORTANT METAL, AND ENERGY MINING AND

PROCESSING, INDUSTRIES EARLIER IN THE YEAR TENDED TO DELAY THE RECOVERY, AS DID THE DISLOCATIONS CAUSED BY THE FLOODS LAST SPRING.

MOST OF THE IMPROVEMENT SO FAR HAS BEEN CENTERED IN RESIDENTIAL AND NONRESIDENTIAL CONSTRUCTION ACTIVITY AND IN THE DEMAND FOR HIGH TECHNOLOGY MANUFACTURED PRODUCTS FOR DEFENSE AND SPACE PURPOSES. LIKE THE REST OF THE NATION, THE DROP IN MORTGAGE INTEREST RATES HAS SPURRED HOMEBUILDING AND SALES IN THE STATE, WHILE HIGHWAY AND POWER PLANT CONSTRUCTION HAS HELPED TO BOOST NONRESIDENTIAL CONSTRUCTION EXPENDITURES AND EMPLOYMENT. UTAH'S AIRCRAFT, MISSILES, AND SPACE INDUSTRIES ALSO HAVE BEEN BENEFITING FROM A SHARP INCREASE IN DEFENSE SPENDING.

DESPITE THESE IMPROVEMENTS, UTAH'S OVERALL GROWTH IS LIKELY TO BE MODEST THIS YEAR AND INTO 1984. MORE BUOYANT GROWTH WOULD REQUIRE A SIGNIFICANT PICKUP IN ITS METAL AND ENERGY MINING OPERATIONS, AND THE PROSPECT FOR THAT HAPPENING IS NOT ENCOURAGING. U.S. AUTO, HOUSING AND APPLIANCE INDUSTRIES HAVE BEEN INCREASING THEIR CONSUMPTION OF METALS BUT THIS HAS BEEN OFFSET BY BOOSTS IN FOREIGN PRODUCTION, SO THAT PRODUCER INVENTORIES ARE STILL EXCESSIVE AND PRICES REMAIN DEPRESSED. SIMILARLY, UTAH'S COAL PRODUCERS PROBABLY WILL CONTINUE TO OPERATE IN AN ATMOSPHERE OF ABUNDANT WORLDWIDE ENERGY SUPPLIES AND RELATIVELY LOW PRICES, WHILE URANIUM MINING WILL REMAIN DEPRESSED AS A RESULT OF THE PROBLEMS CONFRONTING NUCLEAR POWER PLANT CONSTRUCTION. RELATIVELY LOW ACTIVITY IN THESE INDUSTRIES IN TURN HOLDS DOWN THE DEMAND FOR MINING EQUIPMENT AND RELATED SUPPLIES MANUFACTURED IN UTAH.

PROSPECTS ARE SOMEWHAT BRIGHTER IN AGRICULTURE, WHERE UTAH GRAIN PRODUCERS ARE LIKELY TO EARN MORE BECAUSE OF HIGHER PRICES CAUSED BY

THIS YEAR'S MIDWESTERN DROUGHT. BUT THESE SAME HIGH GRAIN PRICES WILL RAISE LIVESTOCK FEED COSTS AND MAY FORCE SOME REDUCTION OF UTAH HERDS AT BELOW BREAK-EVEN PRICES.

Homebuilding -- AN ACTIVITY THAT HAS CONTRIBUTED GREATLY TO UTAH'S AND THE NATION'S ECONOMIC RECOVERY THIS YEAR -- IS LIKELY TO PROVIDE LESS STIMULUS IN 1984. GIVEN THE HUGE INCREASE IN HOUSING STARTS ALREADY ACHIEVED THIS YEAR, HOUSING STARTS IN UTAH MAY BE UP A SMALLER PERCENTAGE NEXT YEAR -- AND THAT GAIN WILL BE DEPENDENT UPON A DECLINE IN MORTGAGE INTEREST RATES. CONCERN OVER THE CURRENT AND FUTURE STATE OF INTEREST RATES IS ONE OF THE TOPICS I WANT TO TURN TO NEXT.

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 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 7.9 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. 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 18 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 THE REAGAN 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. UNDER THE REAGAN ADMINISTRATION, 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 REAGAN 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.

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 ALL OF OUR BASIC INDUSTRIES. THIS CAN BEST BE ACCOMPLISHED BY HAVING FINANCIAL MARKETS, PARTICULARLY LONG-TERM CAPITAL MARKETS, THAT 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 BALANCED RECOVERY IN THE U.S. ECONOMY WILL BE POSSIBLE WITHOUT FURTHER DECLINES IN REAL INTEREST RATES. HOWEVER, THE FEDERAL RESERVE'S POLICY OF PROVIDING ENOUGH MONEY TO SUSTAIN A NON-INFLATIONARY RECOVERY CANNOT CONTRIBUTE TO REDUCING REAL INTEREST RATES. ONLY A DECLINE IN THE FEDERAL GOVERNMENT'S VORACIOUS DEMAND FOR CREDIT CAN DO THAT. IF CONGRESS AND THE ADMINISTRATION FAIL TO CURB ENORMOUS BUDGET DEFICITS, THE RESULTING SQUEEZE ON CAPITAL INVESTMENT THREATENS TO UNDERMINE OUR LONG-TERM PROSPECTS FOR REAL GROWTH AND HIGHER STANDARDS OF LIVING. THE MAJOR RISK IN THE CURRENT SITUATION IS NOT AN ACCELERATION OF INFLATION OR A BUSINESS CYCLE RECESSION IN 1984, BUT A LONG, SLOW DETERIORATION IN THE ABILITY OF THE U.S. ECONOMY TO DELIVER A RISING STANDARD OF LIVING FOR ALL OF US.