THE FEDERAL RESERVE
AND THE BUSINESS OUTLOOK

REMARKS OF
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MEETING WITH
PORTLAND COMMUNITY LEADERS

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Overview

The U.S. economy is almost half way through the second year of the economic recovery that began at the end of 1982. The momentum of the recovery has carried the economy to new high ground above the pre-recession peak of mid-1981. This record is all the more impressive because the 1981-82 recession was the most severe in the post-World War II period. The performance on the inflation front has been equally impressive, with the rate of increase in prices remaining substantially below the double-digit figures experienced in 1980-81.

These large gains represent the good news about the economy. The bad news is that not all sectors have shared in the recovery. By historical standards, our export and import-competitng industries are unusually weak for this stage of an economic expansion. Moreover, recent increases in interest rates have raised concern in some quarters that this weakness already may be spreading to housing and threatening to make inroads into business capital spending as well. At the same time, there is a growing anxiety that the continuing strength of the recovery may undermine the substantial progress we have achieved in taming inflation.

In my talk today, I would like to focus on these concerns about inflation, high interest rates, and their effect on the economy. Before I turn to these points, however, I would like to review briefly the recent

ECONOMIC RECOVERY

Measured by the growth in real GNP -- the most comprehensive measure of all the goods and services produced in the U.S. economy -- the economy expanded at a 6.2 percent rate in 1983. This is just below the average rate experienced in the first year of previous recoveries. The figure for the first quarter of this year showed a much stronger 8.8 percent clip (measured at an annual rate), putting real GNP 5.3 percent above its pre-recession peak in mid-1981.

The gains in industrial production and employment have been just as impressive. Industrial production has grown nearly 21 percent since its recession low in November 1982, and now stands 4.5 percent above its pre-recession peak in 1981. This sharp rebound in production has pushed the capacity utilization rate -- a measure of how much of the economy's total usable plant and equipment is in production -- from a recession low of 68.5 percent to 82.3 percent in April.

Improvement in the employment numbers has been equally gratifying. Since it began in December 1982, the recovery has added an average of 350,000 workers each month to the employment rolls. In May of 1984, the latest month for which figures are available, total employment surpassed by
NEARLY 2.7 MILLION THE NUMBER EMPLOYED AT THE PREVIOUS
EXPANSION PEAK IN 1981. THIS HEALTHY GROWTH HAS PRODUCED A
RELATIVELY STEEP DROP IN THE UNEMPLOYMENT RATE FROM ITS
RECESSION PEAK OF 10.8 PERCENT TO 7.5 CURRENTLY.

BY HISTORICAL STANDARDS, AN UNEMPLOYMENT RATE OF 7.5
PERCENT IS STILL HIGH IN ABSOLUTE TERMS FOR THIS STAGE OF A
BUSINESS RECOVERY. IN PART, THIS IS BECAUSE THE ECONOMY HAS
BEEN RECOVERING FROM THE WORST RECESSION OF THE POSTWAR
PERIOD. BUT MORE IMPORTANTLY, THE HIGH UNEMPLOYMENT RATE
REFLECTS PROFOUND CHANGES IN THE LABOR MARKET OVER THE PAST
TWENTY YEARS AS THE BABY BOOM HAS GROWN UP AND JOINED THE
WORK FORCE, AND WOMEN HAVE ENTERED THE JOB MARKET IN
UNPRECEDENTED NUMBERS. THESE DEVELOPMENTS HAVE RAISED THE
UNEMPLOYMENT RATE CORRESPONDING TO FULL EMPLOYMENT --PERHAPS
TO AS HIGH AS 6.5 PERCENT ACCORDING TO SOME ESTIMATES.
VIEWED FROM THIS PRESPECTIVE, AN UNEMPLOYMENT RATE OF 7.5
PERCENT IS NOT AS HIGH AS IT FIRST APPEARS, ALTHOUGH I WOULD
ADD THAT THIS DOES NOT MEAN WE SHOULD BE COMPLACENT ABOUT
IT.

INFLATION IMPROVEMENT

THE RECENT INFLATION RECORD IS A REMARKABLE ACHIEVEMENT
IN LIGHT OF THE SEEMINGLY UNSTOPPABLE PRICE SPIRAL THAT HAD
PREVAILED OVER THE PREVIOUS DECADE. IT IS EASY TO FORGET
NOW THAT, IN THE SUMMER OF 1980, THE TWELVE-MONTH RATE OF
INCREASE IN CONSUMER PRICES WAS 10.5 PERCENT. IN CONTRAST,
DESpite some INDICATIONS IN THE LAST COUPLE OF MONTHS THAT

THE FEDERAL RESERVE'S MONETARY POLICY PROGRAM OVER THE PAST FIVE YEARS TO BRING DOWN INFLATION HAS BEEN THE MAIN REASON FOR THESE IMPROVEMENTS IN THE PRICE PICTURE. BUT THIS SUCCESS WAS ACHIEVED AT GREAT COST IN TERMS OF DISRUPTIONS AND READJUSTMENTS IN THE ECONOMY. IT IS ESSENTIAL THEREFORE THAT WE GUARD AGAINST RE-CREATING THE CIRCUMSTANCES THAT LED TO DOUBLE-DIGIT INFLATION IN THE 1970S AND EARLY 1980S.

NATIONAL OUTLOOK FOR 1984-1985

THE RESEARCH STAFF AT OUR BANK IS FORECASTING A GRADUAL SLOWING OF THE ECONOMY IN 1984 AND 1985 FROM THE 6.2 PERCENT RATE OF GROWTH EXPERIENCED IN 1983. THE RAPID 8.8 PERCENT GROWTH (ANNUALIZED BASIS) IN 1984'S FIRST QUARTER IS NOT EXPECTED TO CONTINUE AS THE RAPID INVENTORY ACCUMULATION OF THAT QUARTER FALLS BACK TO MORE SUSTAINABLE LEVELS. FOR 1984 AS A WHOLE, REAL GNP IS EXPECTED TO GROW AROUND 5 PERCENT, MEASURED FROM THE FOURTH QUARTER OF LAST YEAR THROUGH THE FOURTH QUARTER OF THIS YEAR.

FOR 1985, THE ESTIMATE IS 3.3 PERCENT, WHICH MANY ECONOMISTS REGARD AS APPROXIMATELY THE RATE OF GROWTH THAT
CAN BE SUSTAINED BY THE ECONOMY IN THE LONG-RUN. HOWEVER, THIS FORECAST HINGES TO AN IMPORTANT DEGREE ON WHAT HAPPENS TO INTEREST RATES FROM NOW ON. FURTHER INCREASES IN RATES OF THE MAGNITUDE WE HAVE SEEN RECENTLY ARE CERTAIN TO CURB SPENDING ON HOUSING, BUSINESS PLANT AND EQUIPMENT AND CONSUMER DURABLES SIGNIFICANTLY, RESULTING IN MUCH MORE SLUGGISH GROWTH IN 1985 THAN WE HAVE FORECAST.

The jobless rate is forecast to fall to around 7.0 percent by the end of 1984 and to average about 6.5 percent in 1985. As I mentioned earlier, according to some estimates a 6.5 percent unemployment rate may indicate the economy is operating close to full employment. As for inflation, it is not anticipated to climb significantly in the next two years. The staff’s forecast of the rate of increase in the GNP price index -- the most comprehensive measure of the average level of prices in the economy -- is something less than 5.0 percent in 1984 and about 5.5 percent in 1985.

Inflation Risk

Some worsening in inflation therefore is expected as the recovery proceeds, but the deterioration from 1983’s recorded 4.1 percent should be moderate. Not all forecasters share this relative optimism, however. According to some, continued expansion in economic activity threatens to put upward pressure on wages and prices as labor and product markets become strained. In other words,
THE ECONOMY IS IN DANGER OF "OVERHEATING," TO USE THE FAMILIAR METAPHOR.

Much of the anxiety about overheating appears to focus on the robust 8.8 percent estimate for real GNP growth in the first quarter of this year. However, as I mentioned earlier, we do not expect the economy to grow at this rate for the remainder of the year. About half of the first-quarter growth stemmed from a spurt in business inventories, which probably was temporary. Demand for final products continues to grow at a moderate and sustainable pace, which, as I indicated earlier, we foresee should translate into about a 5 percent rate of growth for 1984 as a whole. The relevant question then is how much inflationary pressure will this generate?

Capacity Utilization and Inflation

At the Federal Reserve Bank of San Francisco, we have found that the overall degree of capacity utilization in the economy provides one useful way of answering this question. Extensive research by my staff has identified a range of utilization rates, lying between 80.0 and 83.5 percent, that are neutral in the sense that historically there has been no observable tendency for inflation to rise or fall when the economy is operating in this range. In contrast, when capacity utilization has gone above this range, inflation has shown a systematic tendency to accelerate.

Our estimate of 5 percent real GNP growth in 1984 translates into capacity utilization that stays within the
NEUTRAL ZONE FOR THE YEAR -- IN OTHER WORDS, SIGNALLING NO SIGNIFICANT OVERHEATING IN 1984. OUR FORECAST OF CAPACITY UTILIZATION IN 1985 ALSO IS WITHIN THE NEUTRAL ZONE. HOWEVER, IN THAT CASE, IT IS MUCH NEARER THE TOP END OF THE RANGE, INCREASING THE RISK SOMewhat THAT INFLATION COULD BE HIGHER IN 1985 THAN I HAVE INDICATED, ALTHOUGH NOT SIGNIFICANTLY SO.

INFLATION AND MONETARY POLICY

IT ALSO IS IMPORTANT, IN DISCUSSING THE INFLATION OUTLOOK, TO KEEP IN MIND MONETARY POLICY'S FIRM COMMITMENT TO CONSOLIDATE AND EXTEND THE GAINS MADE AGAINST INFLATION OVER THE LAST FIVE YEARS. THUS FAR IN 1984, M1 HAS STAYED WITHIN THE 4 TO 8 PERCENT GROWTH RANGE SET BY THE FEDERAL RESERVE FOR THE YEAR. AS PAUL VOLCKER NOTED RECENTLY, THE 1984 GROWTH RANGES FOR M1 AND THE OTHER MEASURES OF MONEY ARE DESIGNED TO ALLOW FOR GROWTH IN THE ECONOMY IN THE NEIGHBORHOOD OF FOUR TO FIVE PERCENT WITH NO SIGNIFICANT ACCELERATION IN PRICES.

HIGH INTEREST RATES

AN ONGOING CONCERN THROUGHOUT THIS RECOVERY HAS BEEN THE HIGH LEVEL OF INTEREST RATES. DESPITE SIZABLE DECLINES FROM THEIR 1980-81 PEAKS, INTEREST RATES DID NOT FALL AS MUCH AS INFLATION. CONSEQUENTLY, REAL INTEREST RATES -- INTEREST RATES AFTER ADJUSTING FOR INFLATION -- HAVE REMAINED UNUSUALLY HIGH DURING THIS RECOVERY. THUS, AS I MENTIONED EARLIER, THE TREND IN CONSUMER INFLATION HAS
DROPPED NEARLY 5.5 PERCENTAGE POINTS FROM ITS PEAK IN 1980. IN CONTRAST, THE YIELD ON AAA CORPORATE BONDS, FOR EXAMPLE, FELL BY ONLY 4 PERCENTAGE POINTS FROM ITS PEAK IN 1981 TO ITS LOW POINT IN MID-1983.

Moreover, since the first of the year, we have witnessed a significant rise in market rates of interest, especially in the longer-term maturities. AAA corporate bond yields, for example, have risen over 100 basis points, from an average of 12.2 percent in January to about 13.3 percent at the end of May. The rise in the 30-year Treasury bond rate has been even more pronounced -- from 11.75 percent in January to 13.9 percent at the end of May.

It is impossible at this point to be absolutely certain what has caused this recent run-up in rates, but there are some obvious candidates. Rising inflation premiums, for example, come to mind. In my view, however, it is difficult to believe that they could account for the recent jump in rates. Current inflation remains low, and there are no indications that the market has revised upward its expectations of future inflation.

Concerns about recent financial developments both in the U.S. and abroad may have unsettled markets somewhat and accounted for some of the rise in rates. But U.S. financial regulators have demonstrated recently that they will act quickly and decisively to contain any problem that emerges, and I would expect that in the event of any future
problem, the Federal Reserve would do its part to provide whatever liquidity and assurances were necessary.

To my mind, the most plausible explanation for the run-up in rates this year is the collision of rising private credit demands with the Treasury's continuing needs to finance the huge federal budget deficit. I, like many others, have been arguing for some time now that this was almost inevitable if something was not done about the deficit. Now, the inevitable may have become real.

In previous business upturns, government credit demands normally moderated as government tax revenues swelled, leaving enough room for growing private credit demands as the economy expanded. In contrast, this recovery has seen a proportionately smaller decline in the deficit because of policy decisions, such as the defense build-up and the tax-cut program, that have tended to increase the deficit. As a result, rising private credit demands have had to compete with a continued strong government demand for funds.

The pick-up in private demand for credit can be seen, for example, in the broad credit aggregate, called domestic nonfinancial debt, that is monitored by the Federal Reserve. Early in the recovery, that aggregate grew at an 8.5 to 9 percent rate; over the last few months it has accelerated to a rate of growth in excess of 12 percent.

High deficits

Some numbers are helpful in appreciating fully the demands the federal deficit makes on the credit markets.
NATIONAL INCOME ACCOUNTS DATA ON SAVING AND INVESTMENT FOR THE FIRST QUARTER ARE NOT YET AVAILABLE, SO I WILL USE 1983 FIGURES AS AN ILLUSTRATION. FOR CALENDAR YEAR 1983, THE FEDERAL DEFICIT WAS $181.6 BILLION. THE SUPPLY OF CREDIT CONTRIBUTED BY DOMESTIC SAVINGS WAS $243.9 BILLION. THUS, THE FEDERAL DEFICIT WAS EQUAL TO A PHENOMENAL 75 PERCENT OF DOMESTIC SAVINGS IN 1983. THIS DID NOT LEAVE ENOUGH TO FINANCE SPENDING ON NEW PLANT AND EQUIPMENT BY AMERICAN BUSINESS OR ON NEW HOUSING, WHICH TOGETHER TOTALLED $94.6 BILLION IN 1983. AS A RESULT, THE UNITED STATES HAD TO BORROW $34.6 BILLION FROM ABROAD TO HELP FINANCE ITS ECONOMY. IN EFFECT, THE FEDERAL DEFICIT WAS PARTLY FINANCED BY DRAWING ON FOREIGN SAVINGS, WITH THIS FOREIGN CONTRIBUTION AMOUNTING TO 19 PERCENT OF THE TOTAL DEFICIT.

FINANCING THE DEFICIT THIS WAY IMPOSES SUBSTANTIAL COSTS ON OUR ECONOMY. IT BEARS A LARGE PART OF THE BLAME FOR THE UNUSUAL WEAKNESS IN THE FOREIGN TRADE SECTOR I MENTIONED AT THE BEGINNING OF MY TALK. THE HEAVY CAPITAL INFLOW FROM ABROAD HAS MEANT A STRONG DEMAND FOR DOLLARS ON FOREIGN EXCHANGE MARKETS THAT, IN TURN, HAS CAUSED THE DOLLAR TO APPRECIATE APPROXIMATELY 30 PERCENT SINCE THE END OF 1980. THIS APPRECIATION HAS MADE IT DIFFICULT FOR OUR EXPORT INDUSTRIES TO COMPETE IN WORLD MARKETS, AND ENCOURAGED IMPORTS AT THE EXPENSE OF DOMESTIC INDUSTRIES THAT PRODUCE THE SAME SORTS OF GOODS AND SERVICES. WE HAVE GOOD EXAMPLES HERE IN THE WEST OF INDUSTRIES THAT HAVE BEEN HURT BY THE
STRONG DOLLAR: TIMBER IN THE PACIFIC NORTHWEST AND ALASKA, WHEAT IN OREGON AND WASHINGTON, AND COMMERCIAL FISHING IN ALASKA.

The net result of the strong dollar has been a staggering deterioration in our foreign trade position. As recently as 1982, we ran a surplus of $4.6 billion on what is called our current account, which includes trade in goods and services, as well as investment income. In contrast, this account was in deficit by $40.8 billion in 1983, and many observers predict that the deficit could double in 1984. The merchandise trade figures, which include goods only, are even more disturbing. We ran a merchandise trade deficit of $60.6 billion in 1983, and the trend set in the first part of this year, if it continues, indicates a deficit for all of 1984 of around $100-120 billion.

These numbers are overwhelming by themselves, but we should not lose sight of their human dimension. It has been estimated that there are over 5 million jobs in the U.S. directly related to exports, and that each $1 billion loss in exports means a loss of 50,000 jobs.

Crowding Out

Beyond the immediate loss of sales and jobs indirectly caused by the deficit, there is a longer-run cost as well. The squeeze on the foreign sector resulting from the budget deficit is a classic example of crowding out. The foreign sector gets fewer resources — is crowded out, in other
WORDS -- SO THAT THE GOVERNMENT CAN HAVE MORE. The cost of this crowding out, of course, is that the indebtedness to foreigners we are accumulating in the process represents a charge on our future income -- a charge that ultimately must be repaid.

The recent run-up in interest rates has raised fears that housing and business spending on plant and equipment also may be crowded out by the deficit. There are already some signs that this may be happening to housing. Housing starts, after running at an annual rate of 2.1 million units in January and February, have slipped back to an average 1.80 million rate in March and April, while the March fall in housing permits of almost seven percent raises concern about the future.

Thus, the message in the federal deficits is pretty clear. The deficits are drawing, or threatening to draw, resources from sectors of the economy that have the best comparative advantage in world markets, or that provide us with housing and sources of economic growth. In other words, they threaten the growth in our standard of living and the productivity of the U.S. economy. In my opinion, this is the major risk in the current situation -- the threat of a long, steady erosion of America's economic growth posed by high and continuing federal deficits.

Concluding Remarks

To sum up, we can be thankful for having made considerable progress towards full recovery over the last
NEARLY YEAR-AND-A-HALF. AT THE SAME TIME, IT HAS BEEN
POSSIBLE TO CONSOLIDATE THE SUBSTANTIAL GAINS MADE AGAINST
THE SEEMINGLY UNSTOPPABLE UPWARD PRICE SPIRAL OF THE PAST
DECADE AND A HALF. IN THE NEAR TERM, IT DOES NOT APPEAR
THAT THE COUNTRY WILL WITNESS EITHER A MAJOR RESURGENCE OF
INFLATION OR ANOTHER BUSINESS DOWNTURN. HOWEVER, HIGH
FEDERAL DEFICITS POSE A MAJOR THREAT TO OUR LONG-TERM
ECONOMIC WELL-BEING. CONGRESS AND THE ADMINISTRATION ARE
NOW KEENLY AWARE OF THE PROBLEM AND HAVE FINALLY UNDERTAKEN
INITIATIVES TO DEAL WITH IT. IT IS TO BE HOPED THAT IN THE
MONTHS AHEAD A MEANINGFUL AND TIMELY SOLUTION CAN BE WORKED
OUT THAT WILL BE DESERVING OF YOUR SUPPORT.