



FEDERAL RESERVE BANK OF SAN FRANCISCO  
Office of the President

# **THE CURRENT EXPANSION AND THE ECONOMIC OUTLOOK**

**Remarks of  
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**Meeting with  
Los Angeles  
Community Leaders**

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## THE CURRENT EXPANSION AND THE ECONOMIC OUTLOOK

### OVERVIEW

THE U.S. ECONOMY IS NOW NEARLY THREE QUARTERS OF THE WAY THROUGH THE SECOND YEAR OF RECOVERY. THE ECONOMY'S OVERALL MOMENTUM IN THE FIRST HALF OF 1984 PICKED UP FROM THE AVERAGE PACE IN 1983 AND INDICATIONS NOW ARE THAT 1984 AS A WHOLE WILL OUTPERFORM 1983. IF SO, IT WILL BE ONLY THE SECOND TIME IN THE POST-WAR PERIOD THAT THE SECOND YEAR OF A RECOVERY HAS BEEN STRONGER THAN THE FIRST.

THIS UNUSUAL PERFORMANCE IN 1984 CAUGHT MOST ECONOMIC OBSERVERS BY SURPRISE, INCLUDING THE RESEARCH STAFF AT OUR BANK. TO A LARGE EXTENT, THE PREDICTED SLOWDOWN IN 1984 WAS BASED ON THE DAMPENING EFFECTS THAT HIGH REAL, OR INFLATION-ADJUSTED, INTEREST RATES WERE EXPECTED TO HAVE ON INTEREST-SENSITIVE SPENDING, PRINCIPALLY HOUSING AND BUSINESS SPENDING ON PLANT AND EQUIPMENT. INTEREST RATES, IN FACT, REMAINED AT HIGH LEVELS IN 1984, PRIMARILY AS A RESULT OF THE FEDERAL BUDGET DEFICIT. IN SPITE OF THIS, THE ECONOMY PICKED UP STEAM.

AS A BASIS FOR DISCUSSING THE OUTLOOK FOR 1984 AS A WHOLE AND FOR 1985, I WOULD FIRST LIKE TO REVIEW WHAT WE HAVE LEARNED FROM THE SURPRISING STRENGTH OF THE RECOVERY IN THE FACE OF CONTINUING HIGH INTEREST RATES. ALSO, I WOULD LIKE TO FOCUS ON ANOTHER IMPORTANT DEVELOPMENT DURING THIS ECONOMIC EXPANSION, NAMELY, THE CONTINUING GOOD NEWS ON THE INFLATION FRONT.

### DEMAND-LED RECOVERY

THE ROBUST GROWTH IN THE ECONOMY'S OUTPUT OF GOODS AND SERVICES THAT WE HAVE BEEN WITNESSING REPRESENTS THE RESPONSE

TO VIGOROUS GROWTH IN TOTAL SPENDING IN THE ECONOMY -- TO GROWTH IN AGGREGATE DEMAND IN OTHER WORDS. MANY ANALYSTS HAVE SINGLED OUT THE STRONG DOSE OF FISCAL STIMULUS TO THE ECONOMY FROM THE FEDERAL BUDGET AS ONE IMPORTANT SOURCE OF THIS AGGREGATE DEMAND STRENGTH.

THE SIZE OF THE STIMULUS IS SUBSTANTIAL. ITS MAJOR ELEMENT HAS BEEN THE ADMINISTRATION'S TAX-REDUCTION PROGRAM WHICH STARTED IN 1981. BECAUSE OF THIS PROGRAM, 1984 WILL WITNESS \$94 BILLION LESS FEDERAL TAXES BEING PAID THAN WOULD HAVE BEEN THE CASE UNDER THE OLD LAW. LEGISLATED INCREASES IN DEFENSE PROGRAMS SINCE 1981 CONTRIBUTED ANOTHER \$25 BILLION TO THE BUDGET'S FISCAL THRUST IN 1984, ALTHOUGH THIS FACTOR WAS MORE THAN OFFSET BY CUTS IN NON-DEFENSE PROGRAMS. BUT ON BALANCE THE NET FISCAL STIMULUS, AS MEASURED BY THE HIGH EMPLOYMENT DEFICIT -- WHICH ABSTRACTS FROM CYCLICAL EFFECTS ON THE BUDGET -- IS STILL SUBSTANTIAL. FOR 1984, IT IS ESTIMATED TO BE \$112 BILLION --EIGHT TIMES LARGER THAN IT WAS JUST THREE YEARS AGO, IN 1981. EVEN MEASURED AS A PERCENT OF GNP, THE HIGH EMPLOYMENT DEFICIT IS LARGER NOW THAN IT WAS DURING THE "GUNS AND BUTTER" DAYS OF THE LATE 1960s.

AT THE TIME THE FULL MAGNITUDE OF FEDERAL DEFICITS BECAME APPARENT, THERE WERE WIDESPREAD CONCERNS THEY WOULD STALL THE RECOVERY BY RAISING INTEREST RATES, THUS DISCOURAGING PRIVATE SPENDING ON HOUSING AND BUSINESS PLANT AND EQUIPMENT. WE AT THE FEDERAL RESERVE BANK OF SAN FRANCISCO ARGUED INSTEAD THAT

THE DEFICIT'S "CROWDING OUT" OF PRIVATE SPENDING WOULD AFFECT PRIMARILY THE COMPOSITION OF THE RECOVERY, AND WOULD NOT REVERSE THE RECOVERY ITSELF. AS WE PUT IT, THE DEFICIT WOULD DISTORT THE RECOVERY BUT NOT ABORT IT. WE WERE RIGHT, AS IT TURNED OUT. HOWEVER, LIKE OTHER ANALYSTS, WE FAILED TO APPRECIATE HOW MUCH OF THE BURDEN OF THE DEFICIT WOULD FALL ON OUR FOREIGN TRADE SECTOR AS HIGH INTEREST RATES IN THE U.S. ATTRACTED FUNDS FROM ABROAD, CAUSING THE U.S. DOLLAR TO APPRECIATE BY 50 PERCENT SINCE 1980.

THIS APPRECIATION HAS MADE IT DIFFICULT FOR OUR EXPORT INDUSTRIES TO COMPETE ABROAD, WHILE OUR INDUSTRIES COMPETING WITH FOREIGN IMPORTS HAVE FOUND THEMSELVES AT A SIGNIFICANT COST DISADVANTAGE. THE CONSEQUENCES ARE OBVIOUS IN THE DRAMATIC DECLINE IN OUR FOREIGN TRADE STATISTICS. IN 1981, OUR CURRENT ACCOUNT, WHICH INCLUDES TRADE IN GOODS AND SERVICES AS WELL AS INVESTMENT INCOME, SHOWED A SURPLUS OF \$6.3 BILLION. RESULTS FROM THE FIRST PART OF THIS YEAR SUGGEST WE COULD END UP RUNNING A DEFICIT OF \$80 BILLION FOR 1984 AS A WHOLE.

#### STRONG PERFORMANCE

IN CONTRAST TO THE FOREIGN TRADE PICTURE, AND DESPITE HIGH INFLATION-ADJUSTED INTEREST RATES THAT ARE UNPRECEDENTED IN THE POST-WAR PERIOD, HOUSING HAS TURNED IN A RESPECTABLE PERFORMANCE IN THIS RECOVERY, WHILE THE TRACK RECORD FOR BUSINESS CAPITAL SPENDING HAS BEEN TRULY IMPRESSIVE. SPENDING ON HOUSING HAS GROWN TWICE AS FAST AS THE AVERAGE OF PREVIOUS

POST-WAR RECOVERIES. AFTER GETTING OFF TO A SLOW START, SPENDING ON BUSINESS OFFICES AND FACTORIES EXPANDED AT A RAPID 26 PERCENT ANNUAL RATE IN THE FIRST TWO QUARTERS OF THIS YEAR. BUSINESS SPENDING ON EQUIPMENT, HOWEVER, IS THE REAL SUCCESS STORY --GROWING OVER 30 PERCENT SINCE THE LAST BUSINESS CYCLE TROUGH, ALMOST TWICE THE TYPICAL PACE OF RECOVERY IN PREVIOUS EXPANSIONS.

WHAT MIGHT ACCOUNT FOR THIS SEEMING IMPERVIOUSNESS TO HIGH INTEREST RATES? IN THE CASE OF HOUSING, DEREGULATION OF INTEREST RATES ON BANK AND THRIFT DEPOSITS HAS ALLOWED THESE INSTITUTIONS TO COMPETE MORE EFFECTIVELY IN RETAINING FUNDS WHEN MARKET RATES OF INTEREST RISE. AS A RESULT, CREDIT FLOWS TO HOUSING HAVE BEEN STABILIZED IN THE FACE OF HIGH RATES, THUS AVOIDING THE EPISODES OF FINANCIAL DISINTERMEDIATION THAT PLAGUED THE HOUSING INDUSTRY IN THE PAST.

ANOTHER INNOVATION TENDING TO BLUNT THE IMPACT OF HIGH INTEREST RATES HAS BEEN THE WIDESPREAD INTRODUCTION OF ADJUSTABLE RATE MORTGAGES, OR ARMS. CURRENTLY ARMS ACCOUNT FOR 65 PERCENT OF NEW MORTGAGE ORIGINATIONS, AND TYPICALLY HAVE PROVISIONS THAT OFFER INITIAL INTEREST RATES 2 TO 2.5 PERCENTAGE POINTS BELOW THE CORRESPONDING RATES ON FIXED-RATE MORTGAGES. IT IS CLAIMED THESE DIFFERENTIALS HAVE ALLOWED A SUBSTANTIAL NUMBER OF FIRST-TIME HOMEBUYERS TO QUALIFY FOR MORTGAGES WHO OTHERWISE WOULD BE SHUT OUT OF THE HOUSING MARKET.

IN THE CASE OF BUSINESS CAPITAL SPENDING, LIBERALIZED DEPRECIATION RULES AND MORE GENEROUS INVESTMENT TAX CREDITS HAVE REDUCED SUBSTANTIALLY THE EFFECTIVE TAX RATE ON NEW CAPITAL PROJECTS. AT THE SAME TIME, THE DRAMATIC DROP IN INFLATION OVER THE PAST THREE YEARS HAS REDUCED THE TAX BURDEN ON CORPORATIONS CREATED BY INFLATION'S OVERSTATEMENT OF INVENTORY PROFITS AND UNDERSTATEMENT OF TRUE DEPRECIATION. TAKEN TOGETHER, CHANGES IN THE TAX CODE AND DISINFLATION HAVE MATERIALLY LOWERED THE EFFECTIVE TAX RATE ON NEW CAPITAL PROJECTS. IN FACT, SOME ESTIMATES INDICATE THAT THE CURRENT EFFECTIVE TAX RATE ON INCOME FROM INVESTMENT ON NEW EQUIPMENT IS APPROXIMATELY ZERO.

#### INFLATION SURPRISE

I WILL RETURN TO THESE ISSUES WHEN I DISCUSS THE GENERAL OUTLOOK FOR THE REMAINDER OF THIS YEAR AND FOR NEXT. HOWEVER, FIRST LET ME TURN TO THE OTHER ECONOMIC "SURPRISE" IN THIS RECOVERY -- THE DRAMATIC REDUCTION IN THE RATE OF INFLATION SINCE 1981, WITH LITTLE EVIDENCE OF A RESURGENCE DESPITE NEARLY TWO YEARS OF ECONOMIC EXPANSION.

IT SEEMED, BY THE END OF THE 1970s, THAT WE WERE LOCKED IN A SPIRAL OF EVER-INCREASING INFLATION. IN 1980, FOR EXAMPLE, CONSUMER PRICES ROSE 12.5 PERCENT FOR THE YEAR; WHOLESALE PRICES, BY 11.75 PERCENT. CONTRAST THAT WITH WHAT HAPPENED SUBSEQUENTLY. FOR 1983, THE CONSUMER PRICE INDEX ROSE BY 3.75 PERCENT FOR THE YEAR, WHILE WHOLESALE PRICES ROSE A MINUSCULE

0.50 PERCENT -- THEIR LOWEST RATE OF INCREASE SINCE 1964. AND FOR 1984 SO FAR, THE RATES OF INCREASE IN THESE INDEXES HAVE REMAINED LOW -- 4.5 PERCENT FOR CONSUMER PRICES, 3 PERCENT FOR WHOLESALE PRICES.

BEFORE WE GET COMPLACENT ABOUT INFLATION, HOWEVER, WE SHOULD NOTE THAT SOME OBSERVERS ARGUE THAT SPECIAL, TEMPORARY FACTORS ARE RESPONSIBLE FOR REDUCING INFLATION AND KEEPING IT DOWN. WHEN THEIR EFFECTS DISSIPATE, INFLATION WILL BOUNCE BACK, IT IS ARGUED -- PERHAPS SUBSTANTIALLY SO. THREE MAJOR FACTORS ARE USUALLY SINGLED OUT: THE DECLINE IN THE PRICE OF OIL, THE HIGH VALUE OF THE DOLLAR ON INTERNATIONAL EXCHANGES, AND THE LARGE AMOUNT OF SLACK IN LABOR AND CAPITAL MARKETS LEFT OVER FROM THE LAST TWO RECESSIONS. LET ME DISCUSS EACH OF THESE IN TURN.

IN SHARP CONTRAST TO THE EXPERIENCE OF THE 1970s, FALLING OIL PRICES SINCE EARLY 1981 HAVE HELPED TO HOLD DOWN RECORDED INCREASES IN PRICES. IT IS ESTIMATED, FOR EXAMPLE, THAT THE OPEC PRICE CUTS IN EARLY 1983 FROM \$35 TO \$29 A BARREL REDUCED INFLATION (MEASURED BY THE GROWTH IN THE GNP PRICE INDEX) BY APPROXIMATELY A HALF A PERCENT IN 1983. IN 1984, IT IS ESTIMATED THAT FALLING OIL PRICES WILL DEPRESS THE INFLATION RATE BY APPROXIMATELY ONE PERCENTAGE POINT FROM WHAT IT OTHERWISE WOULD HAVE BEEN.

SIMILARLY, THE 50 PERCENT APPRECIATION OF THE FOREIGN EXCHANGE VALUE OF THE DOLLAR SINCE 1980 HAS LOWERED INFLATION

BY REDUCING THE COST OF IMPORTED MATERIALS AND BY KEEPING COMPETITIVE PRESSURE ON DOMESTIC PRODUCERS, BOTH ON THE WAGE AND ON THE PRICE FRONTS. ESTIMATES MADE BY THE FEDERAL RESERVE INDICATE THAT THE OVERSEAS STRENGTH OF THE DOLLAR HAS REDUCED INFLATION BY APPROXIMATELY 1 TO 1.5 PERCENTAGE POINTS IN EACH OF THE LAST THREE YEARS.

FINALLY, IT IS ARGUED THAT HIGH RATES OF UNEMPLOYMENT AND UNUSED FACTORY CAPACITY CAUSED BY TWO RECESSIONS ALMOST BACK TO BACK FROM 1980 TO 1982 KEPT A TIGHT LID ON WAGE AND PRICE INCREASES. ESPECIALLY DRAMATIC WAS THE UNWINDING OF UNION WAGE INCREASES, WHICH IN 1983 DIPPED BELOW THE RATE OF INCREASE IN NON-UNION WAGES FOR THE FIRST TIME SINCE 1978.

#### HOW MUCH PROGRESS?

THE MAJOR UNRESOLVED ISSUE ON THE INFLATION FRONT IS THE EXTENT TO WHICH THESE FACTORS -- OIL, THE DOLLAR, SLACK IN THE ECONOMY -- HAVE BEEN RESPONSIBLE FOR THE DRAMATIC REDUCTION IN INFLATION. IN OTHER WORDS, WHAT WOULD THE RATE OF INFLATION BE IF WE TAKE AWAY THE EFFECTS OF THE SPECIAL ENERGY AND EXCHANGE RATE "SHOCKS" AND ASSUME THE ECONOMY IS CLOSER TO A NORMAL OPERATING LEVEL. THE RESULT IS PROBABLY A MORE ACCURATE MEASURE OF THE UNDERLYING RATE OF INFLATION IN THE ECONOMY.

LET ME ILLUSTRATE WITH SOME FIGURES. AS I MENTIONED EARLIER, INFLATION, AS MEASURED BY THE CONSUMER PRICE INDEX OR CPI, ROSE SOMEWHAT LESS THAN 4 PERCENT IN 1983. THE ESTIMATES I QUOTED SUGGEST THAT THE APPRECIATION OF THE DOLLAR AND OIL



PRICE DECLINES TOGETHER DEPRESSED THE RATE OF INFLATION APPROXIMATELY 2.5 TO 3.0 PERCENTAGE POINTS. ABSTRACTING FROM THESE SPECIAL FACTORS INDICATES THAT THE UNDERLYING INFLATION RATE IS NEARER 6.5 TO 7.0 PERCENT THAN IT IS TO 4.0. MOREOVER, THE SLACK THAT HAD EXISTED IN LABOR MARKETS AND FACTORY CAPACITY HAS LARGELY DISAPPEARED SINCE THE VIGOROUS REBOUND OF THE ECONOMY IN EARLY 1983. AS A RESULT, THERE WILL BE LESS PRESSURE TO HOLD DOWN WAGE AND PRICE INCREASES.

IN BRIEF, WE INDEED HAVE SEEN GOOD NEWS THUS FAR ON THE INFLATION FRONT. BUT A REVIEW INDICATES THAT IT WAS CAUSED IN PART BY TEMPORARY FACTORS THAT WE CANNOT COUNT ON IN THE PERIOD AHEAD. THIS PROSPECT EXPLAINS THE CONTINUED EMPHASIS IN THE FEDERAL RESERVE'S MONETARY POLICY ON THE NEED TO COMBAT A RESURGENCE OF INFLATION PRESSURES, WHILE STILL STRIVING TO PROMOTE FURTHER ECONOMIC GROWTH. INFLATION MAY BE DORMANT, BUT IT IS NOT DEAD.

#### NATIONAL OUTLOOK FOR 1984-85

LET ME NOW TURN TO A DISCUSSION OF THE NATIONAL OUTLOOK. AVAILABLE DATA ON REAL, OR INFLATION-ADJUSTED GROSS NATIONAL PRODUCT SHOWS THE ECONOMY EXPANDED AT AN 8.8 PERCENT RATE IN THE FIRST HALF OF 1984, UP SIGNIFICANTLY FROM THE AVERAGE 6.3 PERCENT RATE FOR ALL OF 1983. IT IS MY STAFF'S OPINION THAT THE ECONOMY'S PERFORMANCE FOR THE SECOND HALF OF 1984 WILL FALL BACK FROM THE FIRST HALF RATE TO A MORE SUSTAINABLE PACE, SO THAT 1984 AS A WHOLE WILL SHOW A 6.5 PERCENT RATE OF GROWTH.

RECENT DATA, SUCH AS THE DROP IN THE INDEX OF LEADING ECONOMIC INDICATORS, SUPPORT THE IDEA THAT A SLOWDOWN IN THE ECONOMY IS OCCURRING.

I EMPHASIZE, HOWEVER, THAT THESE NUMBERS ARE SIGNALLING ONLY A PULL-BACK FROM THE RAPID PACE OF ACTIVITY IN THE FIRST HALF OF THIS YEAR, NOT A RECESSION. STILL, EVEN WITH THIS SLOWDOWN, THIS SECOND YEAR OF RECOVERY IS LIKELY TO OUTPERFORM THE FIRST -- ONLY THE SECOND TIME IN THE POST-WAR PERIOD THIS HAS HAPPENED. MOREOVER, THE OTHER EPISODE -1971-72 --PROBABLY CAN BE EXPLAINED BY THE IMPOSITION OF PRICE CONTROLS THEN, WHICH IS NOT THE CASE NOW.

FOR 1985, OUR ESTIMATE OF REAL GNP GROWTH IS 3.2 PERCENT, WHICH MANY ECONOMISTS REGARD AS APPROXIMATELY THE RATE THAT CAN BE SUSTAINED BY THE ECONOMY OVER THE LONG-RUN. THE JOBLESS RATE, WHICH STOOD AT 7.5 PERCENT IN AUGUST, THE LATEST MONTH FOR WHICH DATA ARE AVAILABLE, IS FORECAST TO FALL TO SOMETHING UNDER 7.0 PERCENT BY THE END OF 1984 AND TO AVERAGE ABOUT 6.5 PERCENT IN 1985. ACCORDING TO SOME ESTIMATES, A 6.5 PERCENT UNEMPLOYMENT RATE INDICATES THAT THE ECONOMY IS OPERATING CLOSE TO FULL EMPLOYMENT.

AS FOR INFLATION, IT IS NOT ANTICIPATED TO CLIMB SIGNIFICANTLY DURING THIS OR NEXT YEAR. THE STAFF'S INFLATION FORECAST, MEASURED IN TERMS OF THE RATE OF INCREASE IN THE PRICE INDEX FOR GROSS NATIONAL PRODUCT, IS ABOUT 4 PERCENT IN 1984 AND BETWEEN 5 AND 5 1/2 PERCENT IN 1985. THESE COMPARE

WITH AN ACTUAL RATE OF 3.8 PERCENT FOR ALL OF 1983, AND CONTINUE TO REPRESENT A SUBSTANTIAL IMPROVEMENT OVER THE DOUBLE-DIGIT INFLATION RATES EXPERIENCED IN 1980-81.

### SECTORAL OUTLOOK

CONSUMER SPENDING, WHICH LED THE ECONOMIC RECOVERY IN 1983, NOW IS EXPECTED LARGELY TO FOLLOW EVENTS AND HAVE LITTLE INDEPENDENT EFFECT ON HOW THE EXPANSION UNFOLDS. IN CONTRAST, DEVELOPMENTS IN BUSINESS CAPITAL SPENDING AND HOUSING WILL PLAY KEY ROLES IN SHAPING THE SLOWER GROWTH IN LATE 1984 AND 1985 THAT I HAVE JUST DESCRIBED.

MY STAFF IS FORECASTING THAT FOR 1984 AS A WHOLE BUSINESS CAPITAL SPENDING WILL GROW AT A HEFTY 18.5 PERCENT ANNUAL RATE DESPITE SOME SLOWDOWN IN THE SECOND HALF OF THE YEAR FROM THE RAPID 20.6 PERCENT RATE OF THE FIRST HALF. FOR 1985 AS A WHOLE, THE PACE OF INVESTMENT SPENDING WILL SLOW FURTHER TO A 6.3 ANNUAL RATE, STILL A RELATIVELY STRONG PERFORMANCE FOR THE THIRD YEAR OF AN ECONOMIC RECOVERY. DELAYED REACTIONS TO THE INCREASES IN REAL INTEREST RATES THAT HAVE OCCURRED SINCE THE END OF 1983 ARE THE MAIN REASON FOR THIS SLOWDOWN. ALSO, SLOWER GROWTH IN CONSUMER DEMAND AS THE ECONOMY'S PACE SLACKENS WILL REDUCE THE NEED FOR BUSINESSES TO ADD TO THEIR PRODUCTIVE CAPACITY.

THE PROSPECTS FOR HOUSING ARE LESS ENCOURAGING. IRONICALLY, THE FACTORS THAT HAVE HELPED TO SPUR BUSINESS INVESTMENT ARE WORKING AGAINST HOUSING. THUS, THE 1981-83 CUTS IN PERSONAL INCOME TAX RATES REDUCED THE VALUE OF ITEMIZED TAX

DEDUCTIONS FOR MORTGAGE INTEREST AND REAL ESTATE TAXES AS A MEANS OF SHELTERING INCOME, WHILE SLOWER INFLATION PROBABLY HAS LOWERED ANTICIPATED CAPITAL GAINS FROM HOUSING. MY STAFF IS FORECASTING THAT 1984 AS A WHOLE WILL SEE ABOUT 1.8 MILLION HOUSING STARTS. THEREAFTER, STARTS WILL PEAK SOMETIME IN THE FIRST HALF OF 1985, WITH ABOUT 1.5 MILLION STARTS FOR ALL OF 1985. AGAIN, THIS PATTERN WILL BE LARGELY A CONSEQUENCE OF INCREASES IN REAL INTEREST RATES THAT HAVE OCCURRED SINCE THE BEGINNING OF THIS YEAR. RECENT EVENTS ARE CONSISTENT WITH THESE PREDICTIONS. HOUSING STARTS FOR THE SECOND QUARTER OF 1984 ALREADY HAVE DECLINED RELATIVE TO THE FIRST QUARTER. ALSO, SALES OF NEW HOMES HAVE BEEN RELATIVELY WEAK FOR SEVERAL MONTHS NOW. AND THE INVENTORY OF UNSOLD NEW HOMES AS OF JULY STOOD AT 6.8 MONTHS, ITS HIGHEST LEVEL IN TWO YEARS.

#### CONCLUSION

THE ECONOMY IS NOW APPROACHING THE END OF THE SECOND YEAR OF A RECOVERY THAT HAS PROVED SUPRISINGLY ROBUST, AND GIVES STRONG INDICATION OF CONTINUING FOR AT LEAST ANOTHER YEAR. THE GAINS IN EMPLOYMENT, PRODUCTION AND UTILIZATION OF OUR NATION'S FACTORIES HAVE BEEN GRATIFYING. THEY PROVIDE NO GROUNDS FOR COMPLACENCY, HOWEVER, WHEN WE REMEMBER THAT THE ECONOMY BEGAN THE RECOVERY IN THE DEEPEST RECESSION TROUGH OF THE POST-WAR PERIOD.

AT THE CENTER OF THIS ENCOURAGING ECONOMIC NEWS HAS BEEN THE SUBSTANTIAL DECLINE IN INFLATION SINCE 1980 -- A

PARTICULARLY REMARKABLE ACHIEVEMENT IN LIGHT OF THE SEEMINGLY UNSTOPPABLE PRICE SPIRAL OF THE PREVIOUS DECADE. THE FEDERAL RESERVE'S PROGRAM OF THE PAST FIVE YEARS TO BRING DOWN INFLATION HAS BEEN THE MAIN SOURCE OF THIS IMPROVEMENT IN THE PRICE PICTURE, ALTHOUGH SPECIAL TEMPORARY FACTORS ALSO HAVE PLAYED A PART.

I DO NOT WANT TO LEAVE THE IMPRESSION THAT WE ARE COMPLETELY OUT OF THE WOODS YET. I ALWAYS LIKE TO KEEP IN MIND THE STORY OF THE MAN WHO THREW HIMSELF OFF THE TOP OF A FORTY-STORY BUILDING. AS HE WAS PASSING BY THE SECOND FLOOR SOMEONE YELLED OUT, "HOW'S IT GOING?" AND HE REPLIED, "SO FAR, SO GOOD." TO BEGIN WITH, WE MUST BE CAREFUL TO GUARD AGAINST RE-CREATING THE CIRCUMSTANCES THAT LED TO DOUBLE-DIGIT INFLATION IN THE FIRST PLACE. THIS DOES NOT MEAN HOLDING THE ECONOMY BACK. THE GOAL OF MONETARY POLICY IS TO PROMOTE STABLE PRICES AND SUSTAINED GROWTH. INDEED, THE EVENTS OF THE PAST FEW YEARS HAVE DEMONSTRATED CLEARLY THAT REDUCING INFLATION IS A PRECONDITION TO ACHIEVING SUSTAINED, LASTING ECONOMIC GROWTH.

AS WELL, WE MUST ACT TO REDRESS THE DISTORTIONS AND IMBALANCES CAUSED BY THE FEDERAL DEFICIT. I HAVE BEEN HEARTENED BY THE STEPS TAKEN RECENTLY BY THE ADMINISTRATION AND CONGRESS TO MAKE A "DOWN PAYMENT" ON REDUCING THE DEFICIT. AS WE MOVE INTO 1985, IT WILL BE EVEN MORE VITAL FOR THESE BODIES TO COOPERATE IN REDUCING THE DEFICIT FURTHER SO THAT ALL SECTORS OF OUR ECONOMY MAY SHARE IN THE CURRENT EXPANSION.