

THE CURRENT EXPANSION
AND THE ECONOMIC OUTLOOK

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OVERVIEW

THE U.S. ECONOMY IS NOW BEGINNING ITS THIRD YEAR OF ECONOMIC RECOVERY. AFTER VERY STRONG GROWTH IN THE FIRST HALF OF 1984, THE ECONOMY'S OVERALL MOMENTUM SLOWED SHARPLY IN THE SECOND HALF. FOR THE YEAR AS A WHOLE, HOWEVER, REAL, OR INFLATION-ADJUSTED, GNP EXPANDED 5.3 PERCENT -- A FULL PERCENT MORE THAN AVERAGE FOR THE SECOND YEAR OF AN EXPANSION IN THE POSTWAR PERIOD.

BY SEVERAL MEASURES THIS HAS BEEN THE STRONGEST ECONOMIC RECOVERY SINCE THE KOREAN WAR BOOM. BASED ON PRELIMINARY ESTIMATES FOR THE FINAL QUARTER OF 1984, IT APPEARS THAT REAL GNP GROWTH OVER THE LAST TWO YEARS HAS BEEN FASTER THAN AT THE COMPARABLE STAGE OF ANY PREVIOUS RECOVERY SINCE THE END OF THE KOREAN WAR. THE REVIVAL IN CAPITAL SPENDING BY BUSINESS HAS BEEN TRULY SPECTACULAR, GROWING 15 PERCENT FASTER THAN THE AVERAGE PACE IN POST-1953 RECOVERIES, AND EVEN 9 PERCENT FASTER THAN THE PREVIOUS RECORD DURING THE EISENHOWER BOOM YEARS OF 1954-55. THE IMPROVEMENT IN THE LABOR PICTURE HAS BEEN SIMILARLY IMPRESSIVE, WITH THE DROP IN THE UNEMPLOYMENT RATE DURING 1984 BEING THE LARGEST FOR ANY YEAR SINCE THE KOREAN WAR BOOM. DESPITE THIS, THE LEVEL OF UNEMPLOYMENT -- 7.3 PERCENT IN DECEMBER 1984 -- STILL REMAINS UNCOMFORTABLY HIGH BECAUSE THE EXPANSION STARTED FROM THE DEEPEST RECESSION TROUGH OF THE POSTWAR PERIOD.

THESE IMPRESSIVE STATISTICS ARE EVEN MORE STRIKING WHEN PUT AGAINST THE BACKDROP OF UNUSUALLY HIGH INTEREST RATES AND A STRONG U.S. DOLLAR DURING THE RECOVERY. AS A BASIS FOR

DISCUSSING THE OUTLOOK FOR 1985, I WOULD FIRST LIKE TO REVIEW THE CAUSES OF THE HIGH REAL INTEREST RATES AND STRONG U.S. DOLLAR, AND THEIR EFFECTS.

THE FEDERAL BUDGET DEFICIT

THE CURRENT ECONOMIC EXPANSION HAS BEEN CRITICALLY SHAPED BY THE EFFECTS OF LARGE AND GROWING FEDERAL BUDGET DEFICITS. THE FEDERAL BUDGET DEFICIT ON A UNIFIED BUDGET BASIS FOR 1984 WAS A STAGGERING \$188 BILLION. BETWEEN 1981 AND 1984 THE FEDERAL BUDGET DEFICIT ROSE FROM 2.2 PERCENT TO 4.7 PERCENT OF GNP. THE LATTER FIGURE IS THE HIGHEST OF THE POST-WAR PERIOD, SURPASSING EVEN THE SHARE OF GNP ABSORBED BY THE DEFICIT DURING THE VIETNAM WAR YEARS. MOREOVER, CURRENTLY AVAILABLE PROJECTIONS SHOW THAT IN THE ABSENCE OF LEGISLATIVE EFFORTS TO BOOST REVENUES OR REDUCE SPENDING, THE DEFICIT WILL EXCEED 5 PERCENT OF GNP IN THE NEXT FIVE YEARS -- A RATE SURPASSED ONLY DURING THE CIVIL WAR, THE TWO WORLD WARS AND THE GREAT DEPRESSION. AND, AS YOU MAY HAVE SEEN RECENTLY IN THE PRESS, THERE ARE REPORTS THAT THE THE OFFICE OF MANAGEMENT AND THE BUDGET NOW HAS AN EVEN MORE GLOOMY SET OF DEFICIT PROJECTIONS FOR THIS AND THE NEXT FEW YEARS.

THESE DEFICITS, OF COURSE, HAVE TO BE FINANCED BY GOVERNMENT BORROWING, AND THE TREASURY'S CONTINUING AND SUBSTANTIAL PRESENCE IN CREDIT MARKETS HAS PUT CONSIDERABLE STRAIN ON THESE MARKETS. TO GIVE SOME IDEA OF THE MAGNITUDE OF THE PROBLEM, THE FEDERAL DEFICIT CURRENTLY ABSORBS OVER ONE HALF OF THE NET SAVINGS GENERATED BY U.S. HOUSEHOLDS, BUSINESSES, AND STATE AND LOCAL GOVERNMENTS.

ONE OBVIOUS SYMPTOM OF THIS STRAIN HAS BEEN HIGHER-THAN-NORMAL INTEREST RATES DURING THIS EXPANSION. BY NORMAL I MEAN THE RANGE OF EXPERIENCE FOR INTEREST RATES DURING PREVIOUS ECONOMIC EXPANSIONS. ESTIMATES MADE BY OUR STAFF, FOR EXAMPLE, SUGGEST THAT INTEREST RATES AFTER ADJUSTING FOR INFLATION AND TAXES -- THE REAL, AFTER-TAX RATE OF RETURN, IN OTHER WORDS -- HAVE BEEN 3 TO 4 PERCENTAGE POINTS HIGHER THAN HISTORICAL NORMS FOR SHORT-TERM RATES, AND 2 TO 3 PERCENTAGE POINTS HIGHER FOR LONG-TERM RATES. THESE CONTINUING HIGH REAL INTEREST RATES RAISED FEARS FROM THE VERY BEGINNING OF THE EXPANSION THAT INTEREST-SENSITIVE SPENDING, SUCH AS HOUSING AND PLANT AND EQUIPMENT PURCHASES BY BUSINESSES, WOULD BE DISCOURAGED, IN EFFECT BEING DISPLACED, OR "CROWDED OUT" BY THE GOVERNMENT DEFICIT.

THIS EXPECTATION, HOWEVER, DID NOT TAKE ACCOUNT OF THE REAGAN ADMINISTRATION'S PROGRAM OF PERSONAL AND BUSINESS TAX CUTS, WHICH WORKED TO OFFSET THE DAMPENING EFFECTS OF HIGH REAL INTEREST RATES. ESTIMATES MADE BY OUR STAFF, FOR EXAMPLE, SUGGEST THAT COMPLETION BY 1984 OF THE THREE-YEAR PHASE-IN OF PERSONAL INCOME TAX CUTS UNDER THE ECONOMIC RECOVERY AND TAX ACT OF 1981 BOOSTED CONSUMER INCOMES MORE THAN ENOUGH TO OFFSET THE DEPRESSING EFFECTS OF HIGHER RATES ON BOTH NEW HOUSING AND "BIG TICKET" CONSUMER ITEMS SUCH AS AUTOMOBILES.

BY THE SAME TOKEN, THE TAX INCENTIVES TO BUSINESS PROVIDED BY THE 1981 TAX ACT COMPLETELY OFFSET THE HIGH COST OF EQUITY AND CORPORATE CAPITAL CAUSED BY HIGH INTEREST RATES. PERHAPS IT WOULD BE MORE MEANINGFUL TO TURN THAT STATEMENT AROUND AND SAY THAT HIGH

INTEREST RATES HAVE TENDED TO OFFSET THE IMPACT OF THE TAX INCENTIVES.

IN OTHER WORDS, IF YOU FACTOR IN THE INDIRECT EFFECTS OF THE ADMINISTRATION'S BUDGETARY PROGRAM -- THE EFFECT THE HIGHER DEFICIT HAS HAD ON INTEREST RATES --THE "SUPPLY-SIDE" INCENTIVES FOR CAPITAL SPENDING ON BALANCE HAVE BEEN MUCH SMALLER THAN THEY APPEAR AT FIRST GLANCE. THE EXPLANATION FOR THE BOOM WE HAVE SEEN IN CAPITAL SPENDING DURING THIS RECOVERY -- WHICH HAS BEEN THE STRONGEST OF THE POST-WAR PERIODS -- THEREFORE MUST BE SOUGHT ELSEWHERE. MANY OBSERVERS, FOR EXAMPLE, ATTRIBUTE MUCH OF THE STRENGTH TO THE OPENING-UP OF INVESTMENT OPPORTUNITIES IN SO-CALLED HIGH TECHNOLOGY INDUSTRIES SUCH AS COMPUTERS. ADDITIONALLY, THE NEED FOR BUSINESS TO MODERNIZE BECAUSE OF THE HIGHLY-COMPETITIVE ENVIRONMENT IN WHICH IT NOW OPERATES HAS SHOWN UP IN A SURGE IN SPENDING ON EQUIPMENT, AS OPPOSED TO NEW STRUCTURES.

NEEDLESS TO SAY, THE RESOURCES ABSORBED BY THE DEFICIT HAVE TO BE SQUEEZED OUT OF SOMEWHERE, AND THAT "SOMEWHERE" HAS BEEN THE FOREIGN TRADE SECTOR OF OUR ECONOMY -- U.S. INDUSTRIES WITH SIGNIFICANT EXPORT MARKETS, SUCH AS AGRICULTURE, OR THAT FACE SUBSTANTIAL FOREIGN COMPETITION, SUCH AS AUTOS AND STEEL. THE MECHANISM BY WHICH THIS CROWDING OUT HAS OCCURRED IS ROUNDABOUT, BUT WORTH SPELLING OUT. IT STARTS WITH THE HIGH INTEREST RATES IN THE U.S. THAT WERE A KEY FACTOR, ALONG WITH POLITICAL AND ECONOMIC STABILITY, IN ATTRACTING FUNDS FROM ABROAD. THE RESULTING COMPETITION FOR DOLLARS ON FOREIGN EXCHANGE MARKETS IN

TURN PUT SEVERE UPWARD PRESSURE ON THE FOREIGN VALUE OF THE U.S. DOLLAR.

AS A RESULT OF THIS AND OTHER FACTORS, THE DOLLAR HAS APPRECIATED NEARLY 40 PERCENT SINCE MID-1980. A STRONG DOLLAR MAKES U.S. GOODS EXPENSIVE ABROAD, AND FOREIGN GOODS CHEAP HERE IN THE U.S. THE RESULTING TOLL ON OUR FOREIGN SECTOR HAS BEEN STAGGERING. ONE MEASURE OF OUR INTERNATIONAL ECONOMIC POSITION IS THE BALANCE ON CURRENT ACCOUNT, WHICH INCLUDES BOTH TRADE IN GOODS AND SERVICES AND FLOWS OF INTEREST AND OTHER INVESTMENT INCOME BETWEEN THE U.S. AND THE REST OF THE WORLD. AS LATE AS 1981 WE RAN A SURPLUS ON CURRENT ACCOUNT, WITH EXPORTS AND INVESTMENT INCOME EXCEEDING IMPORTS AND INVESTMENT PAYMENTS BY \$11.5 BILLION. DATA FOR THE FIRST NINE MONTHS OF 1984, WHICH IS ALL THE CURRENTLY AVAILABLE DATA, SHOW THE CURRENT ACCOUNT IN DEFICIT AT AN ANNUAL RATE OF \$103 BILLION. THE FIGURES FOR THE MERCHANDISE TRADE ACCOUNT, WHICH INCLUDES TRADE IN GOODS ONLY, IS EVEN MORE APPALLING: A DEFICIT OF \$126 BILLION AT AN ANNUAL RATE ACCORDING TO DATA THROUGH NOVEMBER 1984.

ALTERNATIVE WAYS OF QUANTIFYING OUR DETERIORATING COMPETITIVE POSITION RELATIVE TO THE REST OF THE WORLD ARE EQUALLY DISMAL. ESTIMATES OF THE NUMBER OF U.S. JOBS LOST BECAUSE OF THE HIGH DOLLAR, FOR EXAMPLE, RANGE FROM 600,000 TO AS HIGH AS 2½ MILLION. ANOTHER REFLECTION OF THE PROBLEM IS THE FAILURE OF EMPLOYMENT IN MANUFACTURING TO GROW DURING THE LAST TWO YEARS DESPITE, AS I NOTED EARLIER, THE STRONGEST RECOVERY OF THE LAST 30 YEARS. ALL OF THE NET INCREASE IN EMPLOYMENT IN THE U.S. SINCE

1981 HAS OCCURRED IN THE SERVICE AREA OF THE ECONOMY, WHICH, BECAUSE MANY TYPES OF SERVICES CANNOT BE EXPORTED OR IMPORTED, IS MUCH BETTER PROTECTED FROM FOREIGN COMPETITION THAN ARE THE MANUFACTURING AND AGRICULTURAL SECTORS.

SOME OBSERVERS HAVE POINTED OUT THAT THE CAPITAL INFLOW TO THE U.S. HAS ITS GOOD SIDE. THE INFLOW AUGMENTED THE POOL OF LOANABLE FUNDS AVAILABLE FOR THE GOVERNMENT AND PRIVATE BORROWERS TO TAP AND THUS HELPED TO KEEP INTEREST RATES LOWER THAN THEY WOULD HAVE BEEN OTHERWISE. THESE FUNDS WEREN'T SPECIFICALLY EARMARKED TO FINANCE THE DEFICIT, OF COURSE, BUT TO THE EXTENT THEY WERE A RESPONSE TO THE PRESSURE OF THE GOVERNMENT DEFICIT ON CREDIT MARKETS THEY CAN BE THOUGHT OF AS HELPING TO FINANCE THE DEFICIT. CURRENTLY, THE CAPITAL INFLOW TO THE U.S. IS ABOUT HALF THE SIZE OF THE FEDERAL GOVERNMENT DEFICIT. THUS IN EFFECT ABOUT HALF OF THE BUDGET DEFICIT IS BEING FINANCED FROM ABROAD.

THE BUDGET DEFICIT, THROUGH ITS EFFECTS ON INTEREST RATES, IS NOT THE ONLY FACTOR AFFECTING THE EXCHANGE VALUE OF THE DOLLAR. POLITICAL STABILITY, LOW INFLATION, VIGOROUS GROWTH AND A DIVERSIFIED RANGE OF INVESTMENT OPPORTUNITIES -- ALL HAVE MADE THE U.S. A PARTICULARLY ATTRACTIVE PLACE TO INVEST IN THE LAST FEW YEARS. IN ADDITION, THE COLLAPSE OF U.S. EXPORTS TO LATIN AMERICA IN THE WAKE OF THE LDC DEBTOR CRISIS HAS TEMPORARILY STOPPED THE NORMAL FLOW OF U.S. BANK LENDING TO THESE COUNTRIES.

I MENTION THESE POINTS BECAUSE, AS I'M SURE YOU'RE AWARE, DESPITE A NOTICEABLE FALL IN INTEREST RATES SINCE LAST SEPTEMBER, THE DOLLAR HAS CONTINUED TO STRENGTHEN. IN MY OPINION, THIS

"ANOMALY," AS SOME WRITERS HAVE PUT IT, IS AN ANOMALY ONLY IF YOU BELIEVE THAT INTEREST RATES ARE THE ONLY THING AFFECTING THE VALUE OF THE DOLLAR. MOREOVER, I BELIEVE THAT THE EVENTS OF THE PAST YEAR HAVE SERVED TO STRENGTHEN EXPECTATIONS THAT THE U.S. WOULD CONTINUE TO BE A GOOD PLACE TO INVEST. THE SLOWING OF THE ECONOMY TO A MORE SUSTAINABLE PACE IN THE LATTER PART OF 1984, FOR EXAMPLE, RELIEVED FEARS THAT INFLATIONARY PRESSURES WOULD BEGIN TO BUILD UP IF THE RAPID PACE OF THE EARLIER PART OF THE EXPANSION CONTINUED. SIMILARLY, THE DECLINE IN INTEREST RATES THAT BEGAN AT THE END OF THE SUMMER ALLAYED CONCERNS THAT THE ECONOMY WAS THREATENING TO STALL. IN ADDITION, WITH WIDESPREAD INDICATIONS THAT THE ECONOMIC PAUSE IS OVER, MANY MARKET OBSERVERS ARE EXPECTING SOME BOUNCEBACK IN INTEREST RATES AS PRIVATE CREDIT DEMANDS STRENGTHEN AND BEGIN TO COMPETE SERIOUSLY AGAIN WITH THE GOVERNMENT'S CONTINUING HEAVY NEEDS.

SLOWDOWN IN 1984

LET ME NOW TURN TO A BRIEF OVERVIEW OF EVENTS IN 1984 THAT WILL PROVIDE THE CONTEXT FOR MY REMARKS ABOUT THE OUTLOOK FOR 1985. AS I'M SURE YOU'RE ALL AWARE, THE ECONOMY SLOWED SIGNIFICANTLY IN THE SECOND PART OF 1984. IN PART, THIS WAS BECAUSE THE RAPID PACE OF INVENTORY ACCUMULATION THAT HAD HELPED FUEL THE RECOVERY THROUGH THE FIRST HALF OF 1984 COULD NOT BE SUSTAINED INDEFINITELY. AT THE SAME TIME, CONSUMPTION AND NEW HOUSING EXPENDITURES WERE NO LONGER GETTING A SHOT IN THE ARM FROM PERSONAL INCOME TAX CUTS, AS THEY HAD FROM 1981 THROUGH 1983. AS A RESULT, SPENDING ON BOTH CONSUMER DURABLES AND RESIDENTIAL

CONSTRUCTION SLOWED SHARPLY WHEN GOVERNMENT AND PRIVATE CREDIT DEMANDS INTENSIFIED AND INTEREST RATES ROSE. FURTHERMORE, THE DETERIORATION IN OUR TRADE BALANCE ALSO PICKED UP IN 1984, HITTING THE HARDEST IN THE THIRD QUARTER, JUST AS SPENDING ON CONSUMER DURABLES AND RESIDENTIAL CONSTRUCTION HAD BEGUN TO WEAKEN. IT HAS BEEN ESTIMATED, FOR EXAMPLE, THAT HAD OUR TRADE ACCOUNT BEEN IN BALANCE IN THE THIRD QUARTER, REAL GNP WOULD HAVE GROWN 6 PERCENT AT AN ANNUAL RATE, RATHER THAN THE ANEMIC 1.6 PERCENT ACTUALLY RECORDED.

THE COMBINATION OF DECLINING CONSUMER DEMAND, THE SURGE IN IMPORTS AND THE FIRST STAGES OF AN INVENTORY CORRECTION REDUCED THE GROWTH OF REAL GNP FROM 8.6 PERCENT IN THE FIRST HALF OF 1984 TO 2.2 PERCENT IN THE SECOND HALF. BY THE FALL, THERE WAS CONCERN THAT THE ECONOMIC EXPANSION WAS ENDING PREMATURELY. HOWEVER, BY YEAR-END THIS PROBABILITY HAD RECEDED SIGNIFICANTLY. NOVEMBER SAW A HEALTHY RISE IN RETAIL SALES AFTER DECLINES IN THE PREVIOUS TWO MONTHS, AS WELL AS A REBOUND OF INDUSTRIAL PRODUCTION, FURTHER GAINS IN PAYROLL EMPLOYMENT AND A STRONG RISE IN THE COMMERCE DEPARTMENT'S INDEX OF LEADING ECONOMIC INDICATORS. IN DECEMBER, INDUSTRIAL PRODUCTION ROSE AGAIN, AND ALTHOUGH RETAIL SALES SHOWED A SLIGHT DECLINE THAT MONTH, MOST OF THIS WAS ATTRIBUTABLE TO WEAK AUTO FIGURES BECAUSE OF SHORTAGES OF SOME MODELS. EXCLUDING AUTO SALES, RETAIL SALES ROSE AT A 6.0 PERCENT ANNUAL RATE IN DECEMBER. IN ADDITION, THE SHARP PICKUP IN NEW HOUSING PERMITS AND NONDEFENSE CAPITAL GOODS ORDERS IN NOVEMBER RAISED HOPES THAT THE APPROXIMATELY 150 BASIS-POINT DECLINE IN LONG-TERM INTEREST RATES

FROM THEIR SEPTEMBER 1984 HIGHS TO THE END OF THE YEAR WAS BEGINNING TO HAVE ITS EFFECT ON INTEREST-SENSITIVE SPENDING.

1985 OUTLOOK

ALL-IN-ALL, HOWEVER, WE ARE UNLIKELY TO SEE A RESUMPTION OF THE BOOM CONDITIONS OF EARLY 1984. FOR 1985 AS A WHOLE, OUR ESTIMATE OF REAL GNP GROWTH IS 3.0 PERCENT, ONLY UP marginally FROM THE ESTIMATED 2.2 RATE OF GROWTH IN THE SECOND HALF OF 1984. IN LARGE PART THIS IS BECAUSE OTHER FACTORS WILL OFFSET THE BOOST TO THE ECONOMY FROM THE LOWER INTEREST RATES OF THE LAST FEW MONTHS.

WITH REGARD TO KEY PARTS OF THE ECONOMY, OUR STAFF IS FORECASTING THAT FOR 1985 AS A WHOLE BUSINESS CAPITAL SPENDING WILL GROW IN REAL TERMS AT A 4.3 PERCENT ANNUAL RATE, NOT SIGNIFICANTLY DIFFERENT FROM ITS ADVANCE OF THE THIRD QUARTER OF 1984 (THE LAST QUARTER FOR WHICH WE HAVE DATA), AND DOWN SUBSTANTIALLY FROM THE 14.6 PERCENT CLIP OF THE FIRST HALF OF THAT YEAR. THE IMPETUS FROM LOWER INTEREST RATES SINCE SEPTEMBER OF LAST YEAR WILL BE OFFSET BY REDUCED INCENTIVES FOR BUSINESSES TO ADD TO THEIR PRODUCTIVE CAPACITY BECAUSE OF A SLOWER GROWTH IN CONSUMER DEMAND. IN ADDITION, OUR STAFF ANTICIPATES THAT WITH SOME OF THE INVESTMENT OPPORTUNITIES IN THE HIGH TECHNOLOGY INDUSTRIES NOW ALREADY EXPLOITED, SPENDING IN THESE AREAS WILL CONTRIBUTE LESS TO THE OVERALL GROWTH IN CAPITAL SPENDING.

THE PROSPECTS FOR HOUSING ARE MORE ENCOURAGING. MORTGAGE RATES HAVE FALLEN FROM AROUND 15 PERCENT LAST MAY TO UNDER 13 PERCENT BY THE END OF 1984 AS THE ECONOMY WEAKENED AND THE DEMAND

FOR CREDIT SLOWED. OUR STAFF IS FORECASTING THAT HOUSING STARTS WILL PICK UP MODESTLY FROM THE CURRENT LEVELS OF AROUND 1.5 MILLION STARTS ANNUALLY TO 1.6 MILLION UNITS BY MID 1985. RECENT EVENTS ARE CONSISTENT WITH THIS PREDICTION. NEW BUILDING PERMITS INCREASED SHARPLY IN NOVEMBER; AND THE AVERAGE MONTHLY MORTGAGE PAYMENT AS A SHARE OF PER CAPITA DISPOSABLE INCOME IS NOW AT ITS LOWEST LEVEL SINCE EARLY 1979.

AS FOR CONSUMER SPENDING, MY OWN VIEW IS THAT RECENT DEVELOPMENTS POINT TOWARDS THIS KEY ECONOMIC VARIABLE PLAYING A MORE SUBSTANTIAL ROLE IN SHAPING THE EXPANSION FROM THIS POINT ON THAN MANY OBSERVERS ARE PREDICTING. I MENTIONED EARLIER THE UNDERLYING STRENGTH IN THE DECEMBER RETAIL SALES NUMBERS. IN ADDITION, THE SOLID INCREASES IN PERSONAL INCOME IN OCTOBER, NOVEMBER AND DECEMBER OF 1984 INDICATE THAT THERE IS A FIRM BASIS FOR RESPECTABLE ADVANCES IN CONSUMER SPENDING IN THE MONTHS AHEAD.

INFLATION IMPROVEMENT

AS FOR INFLATION, WE DO NOT EXPECT IT TO RISE SIGNIFICANTLY IN 1985. THE STAFF FORECAST IS THAT PRICES, AS MEASURED BY THE IMPLICIT PRICE DEFLATOR FOR GNP, ARE EXPECTED TO INCREASE IN THE RANGE OF 4 TO 4½ PERCENT, MEASURED FROM THE FOURTH QUARTER OF 1984 TO THE FOURTH QUARTER OF THIS YEAR. THIS WILL BE UP SOMEWHAT FROM THE ESTIMATED 3.7 PERCENT INCREASE FOR 1984. FOR THE MOST PART, THIS INCREASE DOES NOT INDICATE ANY WORSENING IN THE UNDERLYING FUNDAMENTALS OF INFLATION. IT IS SIMPLY THAT SPECIAL FACTORS THAT HAVE BEEN HELPING TO HOLD INFLATION DOWN TEMPORARILY WILL NOT BE SO STRONGLY PRESENT THIS YEAR.

WE ARE ASSUMING, FOR EXAMPLE, THAT THERE WILL BE NO FURTHER SIGNIFICANT CUTS IN OIL PRICES IN 1985. DECLINING OIL PRICES IN 1983 AND 1984 ARE ESTIMATED TO HAVE REDUCED THE INFLATION RATE BY APPROXIMATELY $\frac{1}{2}$ TO 1 PERCENTAGE POINT DURING THOSE YEARS. WITH A LARGE PART OF THE ADJUSTMENT TO LOWER ENERGY PRICES NOW COMPLETE, HOWEVER, THIS FACTOR WILL CONTRIBUTE LESS TO KEEPING INFLATION DOWN IN 1985 THAN IT DID BEFORE. SIMILARLY, THE STRENGTHENING U.S. DOLLAR OF THE LAST FEW YEARS IS ESTIMATED TO HAVE REDUCED THE INFLATION RATE BY 1 PERCENTAGE POINT FOR EVERY 10 PERCENT INCREASE IN ITS VALUE. AGAIN, BARRING ANY FURTHER SIGNIFICANT RISE IN THE VALUE OF THE DOLLAR, THERE WILL BE LESS DOWNWARD PRESSURE ON INFLATION FROM THIS SOURCE.

I SHOULD ADD THAT THERE IS MORE THAN THE USUAL AMOUNT OF UNCERTAINTY ATTACHED TO THESE PREDICTIONS. THERE IS CONSIDERABLE SPECULATION THAT THERE MAY BE FURTHER CUTS IN OPEC OIL PRICES, WHICH AGAIN WOULD HOLD INFLATION BELOW ITS UNDERLYING TREND. ON THE OTHER HAND, ANY SIGNIFICANT DECLINE IN THE VALUE OF THE DOLLAR COULD GIVE THE RATE OF INFLATION A SUBSTANTIAL, ALTHOUGH TEMPORARY, BOOST.

ALL IN ALL, THE ACHIEVEMENT ON THE INFLATION FRONT HAS BEEN A REMARKABLE ONE. DESPITE TWO YEARS OF THE STRONGEST RECOVERY SINCE THE KOREAN WAR, INFLATION REMAINS LOWER NOW BY ALL THE IMPORTANT MEASURES THAN IT WAS WHEN THE RECOVERY BEGAN. WITH CURRENT INFLATION RATES OF AROUND 2 TO 4 PERCENT, DEPENDING ON WHICH PRICE INDEX YOU USE, IT'S DIFFICULT TO BELIEVE THAT AT THE BEGINNING OF THE 1980S WE SEEMED LOCKED PERMANENTLY INTO DOUBLE-

DIGIT INFLATION. ALTHOUGH, AS I JUST INDICATED, SPECIAL FACTORS SUCH AS OIL AND THE DOLLAR HAVE HELPED, MUCH OF THE CREDIT FOR THIS SUCCESS IN REDUCING INFLATION MUST BE GIVEN TO THE FED'S STRATEGY OVER THE PAST FIVE YEARS OF GRADUALLY BUT SYSTEMATICALLY BRINGING DOWN THE RATE OF MONETARY GROWTH. FORTUNATELY, I HAVE AN IMPECCABLE OUTSIDE SOURCE TO CORROBORATE THIS JUDGMENT. AS YOU PROBABLY SAW, SENATOR PROXMIRE LAST WEEK GAVE THE FEDERAL RESERVE AND ITS CHAIRMAN, PAUL VOLCKER, A "GOLDEN STAR" FOR, AMONG OTHER THINGS, "ITS STUNNING ACHIEVEMENT IN BRINGING DOWN THE RATE OF INFLATION..."

WE ARE NOT OUT OF THE WOODS YET, OF COURSE. FOUR PERCENT INFLATION IS STILL NOT PRICE STABILITY, THOUGH IT'S A LOT CLOSER THAN THE 10 TO 12 PERCENT RATES WE EXPERIENCED NOT SO LONG AGO. AND THERE ALWAYS COULD BE SOME UNPLEASANT SHOCK LYING JUST OVER THE HORIZON. BUT AS PAUL VOLCKER RECENTLY POINTED OUT, THE PRESENT CLIMATE OF LOWER INFLATION, AND THE STABILIZING EFFECT IT HAS ON INFLATION EXPECTATIONS, PROVIDES A FIRM BASIS FOR CONSOLIDATING AND EXTENDING THE GAINS AGAINST INFLATION.

CONCLUSION

AT THE END OF 1984 THE ECONOMY HAD COMPLETED THE SECOND YEAR OF A RECOVERY THAT HAS PROVED SURPRISINGLY ROBUST, AND GIVES INDICATIONS 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 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.

WITH THE DECLINE IN INFLATION HAS COME A SUBSTANTIAL RETREAT IN INTEREST RATES AS EXPECTATIONS OF CONTINUING LOWER INFLATION IN THE FUTURE REDUCED THE PREMIUM INVESTORS DEMANDED TO COMPENSATE FOR RISING PRICES. SOME OF THIS IMPROVEMENT IN RATES WAS LOST IN THE FIRST HALF OF 1984 AS RISING PRIVATE DEMANDS FOR FUNDS COLLIDED WITH THE GOVERNMENT'S LARGE PRESENCE IN CREDIT MARKETS, PUSHING INTEREST RATES UP. SINCE THEN, SLOWER ECONOMIC GROWTH AND ACTIONS BY THE FED TO FACILITATE THE TRANSITION TO A MORE SUSTAINABLE PACE OF EXPANSION HAVE PRODUCED ANOTHER ROUND OF DECLINES IN INTEREST RATES.

WHETHER THIS SECOND ROUND OF GAINS WILL BE MAINTAINED DEPENDS PRINCIPALLY ON WHETHER MEANINGFUL ACTION IS TAKEN TO REDUCE THE DEFICIT. WITHOUT SOME CREDIBLE INITIATIVES IN THIS AREA, WE RUN THE SERIOUS RISK OF SEEING INTEREST RATES MOVE UP AGAIN AS THE ECONOMY ONCE MORE PICKS UP MOMENTUM.

IN MY REMARKS HERE I'VE TRIED TO DOCUMENT SOME OF THE COSTS THESE DEFICITS ARE HAVING ON OUR FOREIGN SECTOR. THERE ARE OTHER COSTS I COULD MENTION, LIKE THE IMMINENT TURNAROUND IN OUR INTERNATIONAL FINANCIAL STATUS FROM NET CREDITOR TO NET DEBTOR TO

THE REST OF THE WORLD. AS ONE OBSERVER PUT IT, WE HAVE MANAGED TO FRITTER AWAY A CREDITOR POSITION BUILT UP OVER 65 YEARS. MY POINT IS NOT TO SCARE YOU, BUT TO MAKE YOU APPRECIATE, IF YOU DON'T ALREADY, THAT THE COSTS OF THE DEFICIT ARE NOT INTANGIBLE, OR THINGS THAT WILL OCCUR ONLY IN THE REMOTE FUTURE.

I HAVE BEEN HEARTENED BY THE GROWING SIGNS THAT COMING TO GRIPS WITH THE DEFICIT APPEARS TO BE THE NUMBER ONE PRIORITY FOR BOTH THE CONGRESS AND THE ADMINISTRATION THIS YEAR. SUCCESS IN PUTTING TOGETHER A MEANINGFUL SOLUTION TO THE DEFICIT PROBLEM IS THE SINGLE MOST IMPORTANT FACTOR IN ENSURING A BALANCED, AND THUS MORE SECURELY SUSTAINABLE, ECONOMIC EXPANSION.