



FEDERAL RESERVE BANK OF SAN FRANCISCO  
Office of the President

**THE ECONOMIC OUTLOOK  
AND THE ROLE OF MONETARY POLICY**

**Remarks of  
John J. Balles, President  
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**Meeting with  
Anchorage, Alaska  
Community Leaders**

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THE U.S. ECONOMY IS WELL INTO THE THIRD YEAR OF A RECOVERY THAT BEGAN AT THE END OF 1982. SINCE MID-1984, WE HAVE SEEN A MARKED SLOWING IN THE PACE OF THE RECOVERY AND THIS HAS RAISED CONCERNS IN MANY QUARTERS. WHAT BEGAN AS ONE OF THE STRONGEST RECOVERIES IN 30 YEARS IS NOW TURNING OUT TO BE ONLY AN AVERAGE ONE BY HISTORICAL STANDARDS. IN THE FIRST YEAR-AND-A-HALF OF THE EXPANSION, REAL (INFLATION-ADJUSTED) GROSS NATIONAL PRODUCT, OR GNP, EXPANDED AT AN AVERAGE OF AROUND 7 PERCENT A YEAR. SINCE MID-1984, THE AVERAGE ANNUAL GROWTH OF REAL GNP HAS SLOWED TO A LITTLE UNDER 2 PERCENT.

OF COURSE, THE RATE OF ECONOMIC GROWTH TYPICALLY SLOWS AS AN EXPANSION GETS OLDER. IN THIS CYCLE, HOWEVER, THE SLOWDOWN HAS BEEN MUCH SHARPER THAN USUAL. WE THINK THIS PATTERN CAN BE TRACED TO AN IMPORTANT EXTENT TO THE SERIOUS IMBALANCE IN THE FEDERAL BUDGET OVER THE LAST FEW YEARS. THROUGH ITS EFFECTS ON INTEREST RATES AND, IN TURN, THE VALUE OF THE DOLLAR OVERSEAS, THE DEFICIT HAS CRITICALLY SHAPED THE COURSE AND THE CHARACTER OF THE RECOVERY.

TODAY I WILL DISCUSS THE BUDGET DEFICIT'S EFFECT ON THE U.S. TRADE BALANCE, AND THE ROLE THIS HAS PLAYED IN THE SLOWDOWN IN ECONOMIC GROWTH OVER THE LAST 12 MONTHS, TURN NEXT TO WHAT THIS MEANS FOR THE ECONOMIC OUTLOOK, AND CONCLUDE WITH THE ROLE THAT MONETARY POLICY HAS PLAYED IN THESE DEVELOPMENTS.

THE BUDGET AND TRADE DEFICITS

BETWEEN 1981 AND THE FIRST HALF OF 1985, THE FEDERAL BUDGET DEFICIT MORE THAN DOUBLED AS A PERCENT OF GNP, RISING FROM 2.2 PERCENT TO 4.7 PERCENT -- THE HIGHEST LEVEL IN THE

POST-WAR PERIOD. IT SURPASSED EVEN THE SHARE OF GNP ABSORBED BY THE DEFICIT DURING THE VIETNAM WAR YEARS. THE MASSIVE FINANCING REQUIRED TO COVER THESE DEFICITS HAS PUT FINANCIAL MARKETS UNDER ALMOST CONSTANT STRAIN. 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.

THE RESULTING UPWARD PRESSURE ON INTEREST RATES RAISED FEARS FROM THE VERY BEGINNING OF THE EXPANSION THAT INTEREST-SENSITIVE SECTORS OF THE ECONOMY -- HOUSING, INDUSTRIAL AND COMMERCIAL CONSTRUCTION, DURABLE GOODS PRODUCERS -- WOULD BE HURT. IN OTHER WORDS, THEY WOULD BE "CROWDED-OUT," AS THE EXPRESSION GOES.

TO AN IMPORTANT EXTENT, HOWEVER, THIS DID NOT HAPPEN. INSTEAD, THROUGH A ROUNDABOUT ROUTE, THE BURDEN OF THE BUDGET DEFICIT HAS FALLEN TO A SIGNIFICANT DEGREE ON THE FOREIGN TRADE SECTOR OF OUR ECONOMY. THIS SECTOR INCLUDES INDUSTRIES WITH SIGNIFICANT EXPORT MARKETS, SUCH AS AGRICULTURE, AND INDUSTRIES THAT FACE SUBSTANTIAL FOREIGN COMPETITION, SUCH AS STEEL. OUR EXPORT INDUSTRIES HAVE SEEN THEIR OVERSEAS SALES LAG BEHIND THAT OF THEIR FOREIGN COMPETITORS, AND IN SOME CASES, ACTUALLY SHRINK. AT THE SAME TIME, IMPORT-COMPETING INDUSTRIES AT HOME HAVE SEEN THEIR MARKET SHARES CONTRACT IN THE WAKE OF A FLOOD OF IMPORTS.

THESE RESULTS ARE TRACEABLE IN THE FIRST INSTANCE TO THE STRONG U.S. DOLLAR, WHICH HAS APPRECIATED NEARLY 40 PERCENT

SINCE MID-1980, EVEN TAKING INTO ACCOUNT THE APPROXIMATE 14 PERCENT DECLINE SINCE LAST FEBRUARY, BUT THE HIGH DOLLAR IN TURN CAN BE TRACED, TO AN IMPORTANT EXTENT, TO THE LARGE FEDERAL BUDGET DEFICIT. BY RAISING INTEREST RATES IN THE U.S., THE DEFICIT HAS ATTRACTED A STRONG DEMAND FOR DOLLARS TO MAKE U.S. INVESTMENTS, AND IN THE PROCESS PUSHED UP THE VALUE OF THE DOLLAR TO EXTRAORDINARY LEVELS.

THE RESULTING DETERIORATION IN THE U.S.'S INTERNATIONAL COMPETITIVENESS HAS LED TO A DUAL DOMESTIC ECONOMY. THIS DUAL DEVELOPMENT SHOWS UP CLEARLY IN THE UNEVEN EMPLOYMENT GAINS ACROSS ECONOMIC SECTORS. OVERALL, THE 8½ MILLION ADDITIONS TO PAYROLLS SINCE THE EXPANSION BEGAN HAVE BEEN MOST GRATIFYING. MUCH LESS REASSURING HAS BEEN THE OUTRIGHT 361,000 DECLINE IN AGRICULTURAL WORKERS, AND THE FAILURE OF EMPLOYMENT IN THE MANUFACTURING SECTOR TO REGAIN THE LOSSES SUFFERED DURING THE 1981-82 RECESSIONS DESPITE TWO-AND-A-HALF YEARS OF SOLID ECONOMIC GROWTH.

ALL OF THE NET INCREASE IN EMPLOYMENT IN THE U.S. SINCE 1981, WHEN THE LAST EXPANSION ENDED, HAS BEEN IN THE SERVICE AREA OF THE ECONOMY. THIS STRIKING DIFFERENCE IN THE PERFORMANCE OF THE MANUFACTURING AND SERVICE SECTORS REFLECTS TO AN IMPORTANT DEGREE THEIR RELATIVE EXPOSURES TO FOREIGN COMPETITION. SIMPLY PUT, IT TYPICALLY IS MUCH EASIER TO EXPORT OR IMPORT A GOOD THAN A SERVICE.

LET ME NOTE PARENTHETICALLY THAT I RECOGNIZE THAT THE BUDGET DEFICIT WAS NOT THE ONLY FACTOR ACCOUNTING FOR THE HIGH

DOLLAR. POLITICAL STABILITY, LOW INFLATION, VIGOROUS GROWTH AND A DIVERSIFIED RANGE OF INVESTMENT OPPORTUNITIES ALL HAVE MADE THE U.S. DOLLAR A PARTICULARLY ATTRACTIVE INVESTMENT VEHICLE DURING THE LAST FEW YEARS. HOWEVER, IN OUR OPINION, THE CONNECTION BETWEEN THE BUDGET AND FOREIGN SECTOR DEFICITS IS CRITICAL BOTH TO UNDERSTANDING WHY THE ECONOMY SLOWED DOWN LAST YEAR, AND TO SHAPING WHAT WE MAY EXPECT FOR THE NEAR FUTURE. LET ME TURN TO THESE POINTS NEXT.

#### SLOWDOWN IN 1984 AND 1985

AS I MENTIONED IN MY OPENING REMARKS, THE ORIGINAL, VIGOROUS PACE OF THE CURRENT ECONOMIC EXPANSION BEGAN TO FADE AFTER MID-1984. THE REASON IS SIMPLY THAT CONDITIONS SPURRING THE EXPANSION WERE DISSIPATING. FOR EXAMPLE, THE SHOT IN THE ARM TO CONSUMER SPENDING AND NEW HOUSING FROM THE 1982-83 TAX CUTS HAD LARGELY WORN OFF BY THEN. BUT MORE IMPORTANTLY, THE DELAYED, ROUNDABOUT EFFECTS OF THE MASSIVE FEDERAL BUDGET DEFICIT IN THE FORM OF A DETERIORATING TRADE BALANCE BEGAN TO BE FELT. WHEREAS THE EFFECTS OF A LARGER BUDGET DEFICIT ON INTEREST RATES AND THE VALUE OF THE DOLLAR TAKE PLACE ALMOST IMMEDIATELY, 12 TO 18 MONTHS ARE NEEDED FOR THE TRADE BALANCE TO RESPOND FULLY TO A STRONGER DOLLAR.

A WORSENING TRADE BALANCE COMING ON TOP OF LESS EXUBERANT DOMESTIC DEMAND SLOWED ECONOMIC ACTIVITY SUBSTANTIALLY. THIS SLOWDOWN WAS REINFORCED BY CUTBACKS IN INVENTORY ACCUMULATION AND BUSINESS PLANT AND EQUIPMENT PURCHASES AS PRODUCERS AND RETAILERS SAW THEIR SALES WEAKEN. THE SEVERITY OF THE

RESULTING ECONOMIC SLOWDOWN HAS RAISED CONCERNS THAT THE ECONOMIC EXPANSION IS IN DANGER OF ENDING. ON THE FACE OF IT, THE RECENTLY RELEASED PRELIMINARY ESTIMATE OF 1.7 PERCENT REAL GNP GROWTH FOR THE SECOND QUARTER IS NOT REASSURING. HOWEVER, A CLOSER LOOK AT THE DETAILS OF THE SECOND QUARTER'S PERFORMANCE SUGGESTS SOMEWHAT STRONGER PERFORMANCE IN THE MONTHS AHEAD.

THE MAJOR CONTRIBUTORS TO THE LOW SECOND QUARTER GROWTH WERE A \$13.3 BILLION DECLINE IN THE RATE OF BUSINESS INVENTORY ACCUMULATION AND A FURTHER \$5.4 BILLION INCREASE IN NET IMPORTS -- THE DIFFERENCE BETWEEN OUR IMPORTS AND EXPORTS. THE UNDERLYING DEMAND FOR GOODS AND SERVICES IN THE ECONOMY REMAINED STRONG, WITH THE TOTAL VOLUME OF PURCHASES BY U.S. HOUSEHOLDS, BUSINESSES AND GOVERNMENT -- OR REAL DOMESTIC SPENDING -- EXPANDING AT A FAST 6.3 PERCENT ANNUAL RATE. PRODUCTION IN THE U.S. ECONOMY DID NOT KEEP PACE WITH THIS DEMAND SIMPLY BECAUSE BUSINESSES CHOSE TO DRAW DOWN THEIR INVENTORIES RATHER THAN INCREASE PRODUCTION AND BECAUSE SOME OF THE DEMAND WAS DIRECTED AT IMPORTED GOODS.

#### OUTLOOK FOR BALANCE OF 1985 AND FOR 1986

IN MY STAFF'S OPINION, THESE TWO DRAGS ON THE ECONOMY WILL NOT BE PRESENT TO NEARLY THE SAME EXTENT IN THE REMAINDER OF THIS YEAR. BUSINESSMEN ARE REPORTED TO BE COMFORTABLE WITH CURRENT LEVELS OF INVENTORIES, AND AS A RESULT, MY STAFF BELIEVES INVENTORY ACCUMULATION WILL PICK UP AND CONTRIBUTE POSITIVELY TO ECONOMIC GROWTH OVER THE NEXT 18 MONTHS.

SIMILARLY, WE EXPECT A RELATIVELY MILD INCREASE IN NET IMPORTS OF NO MORE THAN \$5 BILLION FOR THE BALANCE OF THE YEAR. THIS IS IN STARK CONTRAST TO THE APPROXIMATELY \$20 BILLION DETERIORATION IN THE EXPORT-IMPORT BALANCE DURING THE FIRST TWO QUARTERS OF 1985. IN MY STAFF'S ESTIMATION, THE MAJOR PART OF THE ADJUSTMENT OF THE TRADE BALANCE TO THE DRAMATIC RUN-UP IN THE DOLLAR IS JUST ABOUT OVER. INDEED, MY STAFF IS FORECASTING SOME IMPROVEMENT IN THE EXPORT-IMPORT BALANCE IN 1986 AS THE EFFECTS OF THE APPROXIMATELY 14 PERCENT DEPRECIATION OF THE DOLLAR SINCE FEBRUARY OF THIS YEAR BEGIN TO FILTER THROUGH.

WITH THIS AS BACKGROUND, LET ME TURN TO MY STAFF'S SPECIFIC FORECAST FOR GNP GROWTH. MY STAFF PREDICTS REAL GNP WILL GROW AT AN AVERAGE ANNUAL RATE OF ABOUT 4 PERCENT OVER THE REST OF 1985 -- UP SUBSTANTIALLY FROM THE MEAGER 1 PERCENT GROWTH IN THE FIRST TWO QUARTERS. FASTER GROWTH WILL ALLOW SOME FURTHER PROGRESS AGAINST UNEMPLOYMENT, AND WE EXPECT THE JOBLESS RATE TO FALL TO 7.1 PERCENT BY YEAR-END. FOR 1986, WE SEE GNP GROWTH TAPERING OFF SOMEWHAT TO AN AVERAGE 3.2 PERCENT, MEASURED FOURTH QUARTER OVER FOURTH QUARTER. AT THIS RATE, THE ECONOMY WILL ONLY BE ABLE TO ABSORB NEW ENTRANTS TO THE LABOR FORCE, THUS PRECLUDING ANY SIGNIFICANT DECLINES IN THE UNEMPLOYMENT RATE DURING 1986.

SPENDING ON DURABLES IS EXPECTED TO SHOW MUCH LESS GROWTH THAN IT DID EARLIER IN THE CYCLE WHEN IT WAS THE BENEFICIARY OF THE 1981-83 TAX CUTS. AS A RESULT, CONSUMER SPENDING IN THE SECOND HALF OF 1985 IS EXPECTED TO TAIL DOWN SLIGHTLY -- TO A

LITTLE OVER 4 PERCENT AT AN ANNUAL RATE, COMPARED TO ABOUT 5 PERCENT FOR ALL OF THE FIRST HALF OF THIS YEAR. AS GNP GROWTH SLOWS IN 1986 AND NO SIGNIFICANT FURTHER DECLINES IN THE UNEMPLOYMENT RATE OCCUR, WE EXPECT THE PACE OF CONSUMER SPENDING TO TAPER DOWN STILL FURTHER TO AROUND 2½ PERCENT FOR THE YEAR AS A WHOLE, MEASURED FOURTH QUARTER OVER FOURTH QUARTER.

FOR BUSINESS SPENDING ON PLANT AND EQUIPMENT, OUR STAFF IS FORECASTING REAL 4 TO 5 PERCENT ANNUAL GROWTH FOR 1985 AS A WHOLE, AND 3 TO 4 PERCENT GROWTH IN 1986. HERE, THE 200-300 BASIS POINT DECLINE IN INTEREST RATES THAT BEGAN A YEAR AGO HAS BEEN A STIMULUS, BUT IS TENDING TO BE OFFSET BY SLOWER GROWTH IN CONSUMER SPENDING WHICH REDUCES INCENTIVES FOR BUSINESS TO EXPAND THEIR CAPACITY TO PRODUCE. IN ADDITION, MY STAFF BELIEVES THAT MANY OF THE INVESTMENT OPPORTUNITIES IN NEW HIGH TECHNOLOGY EQUIPMENT THAT ACCOUNTED FOR THE EXUBERANT PACE OF CAPITAL SPENDING EARLIER IN THE CYCLE HAVE LARGELY BEEN EXPLOITED. IN THE FUTURE, THIS AREA WILL CONTRIBUTE LESS TO THE OVERALL GROWTH OF CAPITAL SPENDING.

THE PROSPECTS FOR HOUSING, ANOTHER KEY INDICATOR OF THE STATE OF THE ECONOMY, ARE MORE ENCOURAGING. MORTGAGE RATES HAVE FALLEN FROM AROUND 15 PERCENT A YEAR AGO TO SLIGHTLY OVER 12 PERCENT THIS SUMMER AS THE ECONOMY WEAKENED AND THE DEMAND FOR CREDIT SLOWED. HOUSING STARTS HAVE ALREADY PICKED UP FROM 1.6 MILLION STARTS ANNUALLY AT THE END OF LAST YEAR TO 1.8 MILLION STARTS IN THE SECOND QUARTER. MY STAFF FORECASTS THAT



STARTS IN THE THIRD AND FOURTH QUARTERS WILL AVERAGE AROUND 1.9 MILLION. RECENT STATISTICS ON RISING HOME SALES, AND THE FACT THAT THE AVERAGE MONTHLY MORTGAGE PAYMENTS AS A SHARE OF PER CAPITA DISPOSABLE INCOME IS NOW AT ITS LOWEST LEVEL SINCE EARLY 1979, REINFORCE THIS FORECAST.

### MONETARY POLICY

LET ME NEXT SAY A FEW WORDS ABOUT MONETARY POLICY. THE IMMEDIATE, PRESSING CONCERN OF MONETARY POLICY OVER THE LAST YEAR-AND-A-HALF HAS BEEN TO HELP EASE THE ECONOMY THROUGH ITS ADJUSTMENT TO THE HIGH DOLLAR -- IN OTHER WORDS, TO ENSURE A "SOFT LANDING," AS THE EXPRESSION GOES, SO THAT THE ECONOMIC EXPANSION COULD RESUME.

THIS CONCEPT HELPS TO EXPLAIN OUR RECENT DECISION, TAKEN AT THE JULY MEETING OF THE FEDERAL OPEN MARKET COMMITTEE, TO ADJUST THE M1 TARGET AT MID YEAR TO INCORPORATE THE RAPID 10½ PERCENT AVERAGE GROWTH IN THIS AGGREGATE IN THE FIRST TWO QUARTERS OF THE YEAR. THIS "REBASING," AS IT IS TECHNICALLY CALLED, ALLOWS FOR VERY GENEROUS MONETARY GROWTH FOR THE YEAR AS A WHOLE -- AS HIGH AS AROUND 9 PERCENT, TO BE MORE SPECIFIC.

UNDER ORDINARY CIRCUMSTANCES, THE INFLATIONARY IMPLICATIONS OF SUCH A RAPID RATE OF MONETARY GROWTH WOULD BE DISQUIETING TO SAY THE LEAST. HOWEVER, CIRCUMSTANCES HAVE NOT BEEN ORDINARY. ACCOMPANYING M1'S RAPID GROWTH THIS YEAR HAS BEEN A SHARP DROP IN ITS VELOCITY -- THE RATE AT WHICH IT CIRCULATES IN THE ECONOMY. THIS DECLINE OF ABOUT 5 PERCENT AT AN ANNUAL RATE IS UNUSUAL VIEWED IN HISTORICAL PERSPECTIVE,

WHERE ON AVERAGE A RISE OF 3 PERCENT A YEAR HAD BEEN THE NORM OVER MOST OF THE POST-WAR PERIOD.

THIS FALL IN VELOCITY FOLLOWED A SUBSTANTIAL DECLINE IN INTEREST RATES OF AROUND 150-200 BASIS POINTS AFTER MID-1984, AS THE ECONOMY WEAKENED AND CREDIT DEMANDS SAGGED. THE ENSUING DECLINE IN VELOCITY AND ACCOMPANYING RAPID MONETARY GROWTH, IN OUR OPINION, REFLECTS THE WILLINGNESS OF HOUSEHOLDS AND BUSINESSES TO HOLD LARGER AMOUNTS OF CASH AS THE COST OF DOING SO DECLINED, AS MEASURED BY THE FOREGONE INTEREST ON ALTERNATIVE, HIGHLY-LIQUID INVESTMENTS LIKE TREASURY BILLS. IN THIS RESPECT, THIS EPISODE OF DECLINING VELOCITY IS SIMILAR TO AN EARLIER ONE IN 1982-83, WHICH ALSO FOLLOWED A PERIOD OF SUBSTANTIAL DECLINE IN INTEREST RATES, AND WHICH ALSO WAS ACCOMPANIED BY RAPID MONEY GROWTH.

IN THAT EARLIER EPISODE, IT WAS DECIDED THAT IT WOULD BE APPROPRIATE TO ALLOW THE RAPID MONEY GROWTH BECAUSE IT REPRESENTED A GREATER QUANTITY OF MONEY DEMANDED BY THE PUBLIC AND THEREFORE WAS NOT INFLATIONARY. SUBSEQUENT EXPERIENCE AFTER 1982-83 DEMONSTRATED THAT THIS JUDGMENT HAD BEEN CORRECT, ALTHOUGH I WOULD NOTE IN THIS CONNECTION THAT THIS OUTCOME DEPENDED CRITICALLY ON M1 GROWTH MODERATING SUBSTANTIALLY ONCE THE PERIOD OF PORTFOLIO ADJUSTMENT WAS OVER.

IN MY OPINION, THE RECENT CIRCUMSTANCES OF ANOTHER FALL IN VELOCITY -- LIKE THE LAST ONE FOLLOWING ON THE HEELS OF A SUBSTANTIAL FALL IN INTEREST RATES -- AGAIN ARGUED FOR TAKING A RELATIVELY ACCOMMODATIVE STANCE WITH RESPECT TO THE RAPID M1 GROWTH OF THE FIRST HALF OF THIS YEAR.

IN THE ACCOMPANYING ENVIRONMENT OF WEAK ECONOMIC GROWTH, LOWER INTEREST RATES AND DECLINING VELOCITY, THIS EPISODE OF RAPID MONEY GROWTH DOES NOT, IN MY OPINION, SIGNAL A RESURGENCE OF INFLATION. THE ECONOMY IS NOT YET EVEN CLOSE TO THE POINT WHERE ITS LABOR OR INDUSTRIAL CAPACITY IS LIKELY TO BE STRAINED. THE UNEMPLOYMENT RATE HAS BEEN STUCK AT 7.3 PERCENT FOR OVER A YEAR AND CAPACITY UTILIZATION IN JUNE WAS 80.3 PERCENT, SIGNIFICANTLY BELOW THE 82 PERCENT RATE THAT HISTORICALLY HAS SIGNALLED A RESURGENCE IN INFLATION. MOREOVER, THE ECONOMIC FORECAST THAT I OUTLINED FOR YOU EARLIER DOES NOT ENVISAGE PUSHING THE ECONOMY INTO THE DANGER ZONE WHERE EITHER LABOR OR FACTORY BOTTLENECKS THREATEN HIGHER INFLATION.

MOREOVER, IT IS IMPORTANT TO KEEP IN MIND THAT IT IS THE LONGER RUN TREND IN MONEY GROWTH THAT MATTERS FOR INFLATION. FROM THIS PERSPECTIVE, THE MORE RAPID GROWTH OF M1 IN THE FIRST HALF OF 1985 CAN BE THOUGHT OF AS OFFSETTING TO SOME EXTENT THE RELATIVELY SLOW GROWTH OF M1 IN LATE 1984. THUS, EVEN IF M1 GROWTH FOR THE BALANCE OF 1985 RUNS AT THE UPPER 8 PERCENT BOUND OF THE NEW TARGET, M1 GROWTH OVER THE TWO-YEAR PERIOD, 1985-86, WILL HAVE AVERAGED AROUND 7 PERCENT. IN THE CONTEXT OF RELATIVELY WEAK VELOCITY GROWTH (ABOUT 1 PERCENT OVER THE TWO YEARS), THIS RATE OF MONETARY EXPANSION SHOULD NOT JEOPARDIZE THE GAINS IN INFLATION WE HAVE ACHIEVED OVER THE PAST THREE YEARS. AT THE SAME TIME, IT SHOULD BE SUFFICIENT TO ACCOMMODATE SUSTAINABLE GROWTH IN THE ECONOMY.

CONCLUSION

IN CONCLUDING, LET ME ADD THAT THE FEDERAL RESERVE HAS NOT GIVEN UP ON ITS LONGER RUN STRATEGY OF ULTIMATELY REDUCING MONETARY GROWTH TO RATES THAT ARE COMPATIBLE WITH A REASONABLE PRICE STABILITY. THE CURRENT 3 TO 4 PERCENT INFLATION RATE IS A REMARKABLE ACHIEVEMENT WHEN COMPARED TO THE DOUBLE DIGIT RATES OF ONLY A FEW YEARS AGO.

IN THE FINAL ANALYSIS, HOWEVER, A 3 TO 4 PERCENT INFLATION RATE IS STILL UNACCEPTABLE AS A FINAL GOAL. UNFORTUNATELY, MONETARY POLICY HAS BEEN DISTRACTED FROM ITS LONG-RUN AGENDA OF REACHING REASONABLE PRICE STABILITY BY THE INSISTENT NEED TO KEEP ECONOMIC GROWTH FROM FALTERING IN THE FACE OF SEVERE SECTORAL IMBALANCES. AS PAUL VOLCKER NOTED IN HIS JULY TESTIMONY TO CONGRESS: "THERE ARE OBVIOUS LIMITATIONS TO THIS (PROCESS)... WITHOUT THREATENING THE NECESSARY PROGRESS TOWARD STABILITY UPON WHICH SO MUCH RESTS."

SINCE, AS I HAVE TRIED TO PERSUADE YOU, THESE SECTORAL STRAINS CAN BE TRACED TO AN IMPORTANT EXTENT TO THE LARGE AND PERSISTENT IMBALANCE IN THE FEDERAL BUDGET, MONETARY POLICY IS IN EFFECT BEING HELD HOSTAGE BY AN UNBALANCED FISCAL POLICY. GIVEN THIS, I HAVE BEEN HEARTENED BY RECENT ACTIONS TAKEN BY CONGRESS TO CUT THE DEFICIT. AT THIS POINT, THERE IS APPARENTLY SOME CONFUSION ABOUT THE SUBSTANCE AND PRECISE MAGNITUDE OF THE CUTS. IN THE DAYS TO COME, WE WILL HAVE A CLEARER IDEA OF HOW SIGNIFICANT A STAB HAS BEEN MADE AT REDUCING THE DEFICIT AND WHETHER IT CAN BE MADE TO STICK. ON

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CLOSER ANALYSIS, IT MAY TURN OUT TO BE A MORE TENTATIVE AND  
FALTERING STEP THAN HAS BEEN CLAIMED FOR IT. BUT IT IS  
CERTAINLY A STEP IN THE RIGHT DIRECTION.