THE DOLLAR, MONETARY POLICY AND THE ECONOMIC OUTLOOK

Remarks of
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Southern California Community Leaders

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INTRODUCTION

Last month marked the end of the third year of the current business cycle expansion. In many ways, there are favorable developments to note. Over these three years almost 9 million new jobs were created and the total volume of goods and services produced by the U.S. economy, as measured by inflation-adjusted, or real GNP, increased to a level more than ten percent above its previous peak in 1981. At the same time, the unemployment rate was brought down from 10.7 percent to 7.1 percent. Although this rate remains uncomfortably high relative to historical experience, it is also true that a record number of Americans are at work, with approximately 60 percent of the adult population working in October -- the highest rate in the post-war period.

Moreover, this business expansion has been accompanied by substantial improvement on the inflation front. At the peak of inflation in 1980, the twelve-month rate of change in the Consumer Price Index registered an alarming 14.7 percent annual rate. By contrast, over the last twelve months the index has risen only 3.2 percent, and so far is showing no signs of acceleration. Granted, we are not at
PRICE STABILITY YET, BUT WE HAVE MADE IMPRESSIVE STRIDES OVER THE LAST FIVE YEARS TOWARDS ULTIMATELY ERADICATING INFLATION.

There has been a darker side, however, to the good news I have just reviewed. In the last eighteen months we have seen a marked slowing in the recovery. Related to this has been the markedly uneven composition of the expansion, with some sectors conspicuously failing to share in the overall prosperity—notably agriculture, forestry, mining and some manufacturing industries. This unevenness has showed up, among other ways, in the uncomfortably large differences in state unemployment rates within the Twelfth District.

Some decline in the rate of economic growth is normal as an expansion matures. Indeed, some forecasters have begun to raise the possibility of a recession next year. Although this possibility cannot be ruled out completely, our research staff at the Bank believes at this point that a continuation of the economic expansion through 1986 is still the most likely prospect.

Before I turn to some particulars of this forecast, I would like to give you a little background about the federal budget and trade deficits, the recent behavior of the dollar, and the problems these developments have posed for monetary policy.
The Budget and Trade Deficits

For calendar year 1985, the federal government budget deficit is projected to be a mind-boggling $193 billion. Between 1981 and 1983 the deficit relative to GNP almost tripled to about 5 percent of GNP, and has remained in that neighborhood ever since. There is no precedent in our peace-time history for numbers of this magnitude. Given the deadlock that has prevailed in Congress for the last several years over attempts to come to grips with the budget imbalance, I am not optimistic that the deficit will be cut significantly in the foreseeable future. The protracted debate, for example, in recent weeks over legislation to cut the deficit in connection with raising the federal debt ceiling has only served to confirm this view in my mind.

The federal deficit represents a substantial claim on our nation’s savings, currently absorbing between 45 to 50 percent of the net savings made by households, businesses and state and local governments. This has resulted in some of the traditional “crowding out,” as it is called, of housing and business capital outlays that occur when deficits put upward pressure on interest rates. In this expansion, however, the burden of financing the budget deficit has fallen to a significant extent on the foreign sector of the economy -- in other words, on industries with important export markets or that face heavy competition from foreign imports.
I’m sure you’re all familiar by now with the story of how the growing budget deficit ultimately translated into a depressed foreign sector of the economy. The massive capital inflow from abroad prompted by high interest rates here bid up the value of the dollar by approximately 50 percent between mid-1980 and early 1985. The effect was to make our exports expensive in terms of foreign currencies, while the dollar price of imports to the U.S. fell. As a result, our balance on our international account deteriorated alarmingly as exports grew sluggishly, and in some sectors declined, while imports surged. It now appears that our deficit in trade in goods and services plus investment income for 1985 will reach a record of $140 -$150 billion, an unprecedented figure.

Let me note parenthetically that I recognize that the budget deficit is not the only factor accounting for the high dollar and the impact on our foreign trade. Our political stability, low inflation, vigorous economy, and diversified range of investment opportunities all have made the dollar a particularly attractive investment vehicle in recent years. However, in my opinion, the budget deficit has been the single most important factor producing the sharp run-up in the dollar’s value since 1980.
Uneven Economy

As we’ve all been made aware by now, the strong dollar’s impact on U.S. competitiveness has led to a dual economy. On one hand, from the standpoint of U.S. consumers and tourists, the strong dollar has been a bonanza. On the other hand, U.S. firms competing with overseas businesses have been put at a severe cost disadvantage. Of the 9 million new jobs created since 1982, almost 7½ million have been in the service and trade sectors which are fairly well insulated from import competition. In contrast, there has been little growth in manufacturing employment, and an actual loss of almost a half million jobs in agriculture.

This uneven development has led to increasing demands for protection for a wide range of U.S. industries including agriculture, steel, and textiles. In my opinion, protectionism is not the answer, it does not address the fundamental problem that we as a nation are not saving enough to finance our expenditures for housing and plant and equipment, cover the federal deficit, and be in balance on our international account. Protectionism would only shift the burden of the budget deficit to some other sector, not eliminate it.

Relief for the Dollar

Early this year, the emergence of less optimistic prospects for the U.S. economy, subsequent declines in
INTEREST RATES, AND SUBSTANTIAL FOREIGN EXCHANGE:intervention on the order of $10 billion by the U.S. and other central banks in late February helped to push the dollar down approximately 8 percent between February and September.

These developments were followed by the September agreement by the Group of 5, which consists of the U.S., Japan, the United Kingdom, France and Germany, to coordinate their overall economic policies to encourage further orderly depreciation of the dollar and to support such coordination with foreign-exchange market intervention where appropriate. Since the agreement, the dollar has declined a further 7 percent against other currencies as a whole. Thus, since February there has been a total drop of 15 percent in the trade weighted value of the dollar.

However, the depreciation against individual currencies has varied a great deal. Since the G-5 agreement, the dollar essentially has remained unchanged against the Canadian dollar, has depreciated approximately 15.9 percent against the Japanese yen, and has declined 6.8 percent against the major European currencies.

The decline in the dollar’s value since February has been heartening, but nevertheless the dollar’s value still remains approximately 35 percent above its 1980 base. In my
OPINION, FURTHER SIGNIFICANT PROGRESS IN BRINGING THE DOLLAR DOWN WILL DEPEND UPON, AMONG OTHER THINGS, MEANINGFUL REDUCTIONS IN THE U.S. FEDERAL BUDGET DEFICIT, FOR THE REASONS I HAVE ALREADY DESCRIBED TO YOU. I ALSO HAVE DESCRIBED TO YOU MY VIEWS ABOUT THE LIKELIHOOD OF THAT HAPPENING IN THE FORESEEABLE FUTURE.

IN THIS CONTEXT, IT IS INTERESTING TO NOTE THAT JAPAN, WHOSE CURRENCY HAS MOVED THE MOST AGAINST THE DOLLAR, HAS SUPPORTED ITS FOREIGN EXCHANGE INTERVENTION WITH A RANGE OF DOMESTIC POLICY INITIATIVES. SINCE THE SEPTEMBER MEETING, SHORT-TERM INTEREST RATES HAVE RISEN SIGNIFICANTLY IN JAPAN. IN ADDITION, THE JAPANESE HAVE ANNOUNCED FISCAL INITIATIVES, SUCH AS LOW-INTEREST HOUSING PROGRAMS, TO STIMULATE DOMESTIC DEMANDS, AS WELL AS VARIOUS TECHNICAL CHANGES THAT WILL OPEN UP JAPAN TO FOREIGN PHARMACEUTICAL AND TELECOMMUNICATIONS FIRMS.

**MONETARY POLICY**


THIS GOAL HELPS EXPLAIN THE FED'S CONCERN ABOUT HOW TO RESPOND TO THE RAPID GROWTH OVER THE LAST 12 MONTHS OF 11.5 PERCENT IN THE M1 MONETARY AGGREGATE, WHICH CONSISTS OF
currency and all checkable deposits. This growth has put M1 well above the original 4 to 7 percent M1 target for 1985 adopted last year, and even significantly above the new, higher targets for the second half of the year adopted last July.

Under ordinary circumstances, the inflationary dangers of such a rapid rate of M1 growth would have been cause for concern. But, as Chairman Volcker emphasized recently in his letter to Congressman Walter Fauntroy, Chairman of the House Subcommittee on Domestic Monetary Policy, circumstances have not been ordinary. M1’s rapid growth has been accompanied by a sharp decline in its velocity -- the rate at which it circulates in the economy.

This decline is reminiscent of the decline in velocity in 1982-83 which, in retrospect, appears to have reflected greater business and household willingness to keep larger amounts of currency and checkable deposits on hand as interest rates declined. Although the parallels are not perfect, part of the current decline in velocity and accompanying surge in M1 appears to be the same phenomenon -- a response to the general decline in interest rates that has occurred since mid-1984. Additionally, there has been the effect of deregulation of interest rates payable on checkable deposits.
Because of the uncertainty about M1’s behavior, as well as the concern to prevent the expansion from being derailed by the economy’s adjustments to the budget and trade imbalances, Chairman Volcker indicated in his letter to Congressman Fauntroy that the Federal Open Market Committee, or FOMC, decided that M1 growth above the revised 3 to 8 percent targets would be acceptable. Meanwhile, the other monetary and credit aggregates used as targets by the Fed are generally within the growth ranges set for the year. Under these circumstances, in the setting of monetary policy, particular attention is being given to on-going developments in the economy, in domestic credit markets, and in foreign exchange markets.

**Economic Outlook**

Let me conclude by saying a few words about the economic outlook for the U.S. economy, and for California. Our staff at the Bank is predicting a 3.3 percent expansion in the national economy, as measured by the growth in real GNP between this quarter and the fourth quarter of 1986. This is somewhat higher than the 2 percent gain expected this year, which represented a sluggish first half but a stronger second half.

We expect that consumer spending will continue to grow through 1986 but significantly below the relatively robust rates for the first three quarters of this year, as
households in 1986 build up their depleted savings. At the same time, a relatively low operating rate for factories and widespread vacancies in office space suggest that business’s expenditures on equipment and construction will be sluggish. A recent McGraw Hill survey of business capital spending intentions showed slightly lower dollar outlays next year compared to this. Even after taking into account that survey’s chronic tendency to be pessimistic, and making some reasonable estimates of price increases for capital goods, it still appears that we could end up with business capital spending (in inflation-adjusted terms) growing more slowly next year than this.

However, by the second half of next year, the effects of this year’s depreciation of the dollar will begin to give a boost to the economy as our exports become more competitive abroad and domestic producers are better able to compete with imports. Our staff estimates that the decline to date in the dollar’s value would be sufficient to boost GNP growth in the second half of 1986 relative to its sluggish pace in the first half of the year. At the same time, however, the resulting rise in the price of imports from a depreciating dollar is expected to result in a slight uptick in inflation from this year’s expected rise of about 3½ percent. Finally, it appears that there will be little change in the overall unemployment rate in the economy, recently at a rate of a little over 7 percent.
Finally, let me now turn to a brief discussion of the California economy. In recent months some sectors of the California economy have continued to do very well, despite a slowdown in economic activity statewide. Trade and services, which together make up more that 50 percent of California’s non-agricultural employment base, have proven to be consistently strong sectors of the state’s economy, as is also true for the nation. Aerospace activity, buoyed by defense spending, has provided an additional source of strength. California has increased its share of defense contracts to about 25 percent, arguing for a bright future for the aerospace sector as defense contracts continue to grow.

Construction activity also has remained strong, with a 16 percent increase in the average annual rate of housing starts in the first nine months of 1985. However, continued historically high interest rates, a disinflationary environment, and some indications of overbuilding in office space, cloud the future.

The agricultural sector continues to suffer from the problems of increased world production, a high dollar, and trade barriers abroad, and these problems are likely to persist. Although farmland prices generally have declined less in California than elsewhere in the nation, land used
FOR SUCH CROPS AS ALMONDS AND WINE GRAPES HAS LOST AS MUCH 
AS 50 TO 80 PERCENT OF ITS VALUE IN THE PAST TWO OR THREE 
YEARS.

THE SEMICONDUCTOR INDUSTRY HAS SUFFERED FROM SLOWER 
growth in microcomputer sales and a severe inventory 
overhang from the rapid growth period of 1983 and 1984. 
Additionally, there is now an investigation underway of 
alleged dumping in our markets by certain Japanese producers 
of semi-conductors. Over the longer-run, semiconductor 
markets will expand, provided technological innovation 
continues. But current difficulties leave nearer-term 
prospects less certain.

THE OUTLOOK FOR THE LOS ANGELES-ORANGE COUNTY AREA IS 
brighter than for the state as a whole because strong 
sectors such as defense figure more prominently locally, 
while just the opposite is true for a weak sector such as 
agriculture. This mix of strong and stable sectors should 
provide Southern California with continued, if moderate, 
economic growth.

CONCLUDING REMARKS

IN SUMMARY, WE SEE THE ECONOMIC EXPANSION CONTINUING AT 
a moderate pace through 1986. Some uptick in inflation also 
is likely, although the rate still will be substantially 
below the double digit rates that battered the economy as 
recently as four years ago.
Admittedly the uneven tone as between different sectors of the economy is likely to continue, unless or until the massive imbalance in the Federal deficit is reduced, with a consequent further lowering of both interest rates and the international value of the dollar. Solutions to these problems are beyond the ability of monetary policy alone to remedy. Nevertheless, I believe that The Federal Reserve can take considerable satisfaction from its key role in curbing inflation since 1980, while at the same time seeing the economy as a whole enjoy one of the stronger expansions of the post-war period.