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A PERSPECTIVE ON THE OUTLOOK FOR THE U.S. ECONOMY

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WE ARE NOW IN THE FOURTH YEAR OF THE CURRENT BUSINESS EXPANSION, AND GENERALLY THE U.S. ECONOMY HAS PERFORMED WELL OVER THIS PERIOD. THE PRODUCTION OF GOODS AND SERVICES HAS INCREASED AT JUST UNDER A 4 1/2 PERCENT AVERAGE ANNUAL RATE SINCE 1982. THE UNEMPLOYMENT RATE HAS DROPPED SIGNIFICANTLY FROM A PEAK OF OVER 10 1/2 PERCENT, AND EMPLOYMENT HAS INCREASED BY MORE THAN 9 MILLION.

AT THE SAME TIME, INFLATION, AS MEASURED BY THE CONSUMER PRICE INDEX, WAS 3 3/4 PERCENT OVER THE PAST TWELVE MONTHS, A DRAMATIC DECLINE FROM ITS ALARMING PEAK OF 14 1/2 PERCENT IN THE TWELVE MONTHS ENDING APRIL 1980. THE RELATED DECLINE IN INTEREST RATES HAS BEEN EQUALLY DRAMATIC, WITH THE 30-YEAR TREASURY BOND RATE, FOR EXAMPLE, FALLING FROM A PEAK OF MORE THAN 14 1/2 PERCENT TO BELOW 8 1/4 PERCENT FOR THE FIRST TIME IN 8 YEARS.

BUT THERE HAS BEEN A DARKER SIDE TO THIS GOOD NEWS. SERIOUS TRADE AND INTERNATIONAL FINANCIAL IMBALANCES HAVE THREATENED THE HEALTH OF THE U.S. AND WORLD ECONOMIES THROUGHOUT THE EXPANSION.

MY BASIC MESSAGE IS THAT ALTHOUGH THE PROSPECTS FOR CORRECTING THESE IMBALANCES HAVE IMPROVED, THEY HAVE GREATLY COMPLICATED THE JOB THE FED HAS TO DO. AS A NEW MEMBER OF THE FED, I WOULD LIKE TO GIVE MY PERSPECTIVE ON THESE ISSUES AND TO FINISH UP WITH MY OUTLOOK FOR THE U.S. ECONOMY OVER THE NEXT YEAR OR SO.

DOMESTIC AND INTERNATIONAL IMBALANCES

MASSIVE FEDERAL BUDGET DEFICITS SINCE 1981, AND THE HIGH INTEREST RATES IN THIS COUNTRY THAT FOLLOWED, PROMPTED AN ENORMOUS CAPITAL INFLOW FROM ABROAD, GENERATING IN TURN A LARGE DEMAND FOR U.S. DOLLARS. BETWEEN 1981 AND 1985, THE FEDERAL BUDGET DEFICIT AS A SHARE OF GNP MORE THAN DOUBLED TO 5 PERCENT, AND EXCEEDED \$200 BILLION IN 1985. FROM MID-1980 THROUGH EARLY 1985, THE VALUE OF THE DOLLAR ROSE ALMOST 85 PERCENT. OTHER FACTORS ALSO CONTRIBUTED TO THE STRENGTH OF THE DOLLAR, BUT, IN MY VIEW, THE BUDGET DEFICIT WAS THE SINGLE MOST IMPORTANT FACTOR.

WITH A STRONG DOLLAR, OUR TRADE AND CURRENT ACCOUNTS SWUNG INTO LARGE DEFICITS. ADDING TO THIS PROBLEM WAS LAGGING ECONOMIC GROWTH ABROAD WHICH TRANSLATED INTO SLUGGISH GROWTH IN U.S. EXPORTS. THIS HAS BEEN ESPECIALLY TRUE IN THE EUROPEAN COMMUNITY, WHERE GROWTH OF REAL GNP HAS AVERAGED ONLY ABOUT 1 1/2 PERCENT PER YEAR OVER THE PAST THREE YEARS.

THESE IMBALANCES HAVE HAD BOTH GOOD AND BAD EFFECTS ON THE U.S. AND WORLD ECONOMIES. ON THE POSITIVE SIDE, THE LARGE CAPITAL INFLOW HAS MEANT LOWER U.S. INTEREST RATES BECAUSE WE HAVE BEEN ABLE TO TAP FOREIGN SAVINGS BOTH TO FINANCE OUR BUDGET DEFICIT AND TO PROVIDE FINANCING FOR BUSINESS CAPITAL SPENDING AND HOUSING. AT THE SAME TIME, THE STRONG GROWTH IN OUR IMPORTS HAS PROVIDED A READY MARKET FOR THE REST OF THE WORLD'S GOODS, ESPECIALLY THOSE OF SOME HEAVILY INDEBTED DEVELOPING COUNTRIES.

A STRENGTHENING DOLLAR ALSO HAS MEANT LOWER INFLATION RATES IN THIS COUNTRY. THE RESEARCH STAFF AT THE SAN FRANCISCO FED ESTIMATES THAT THE INCREASE IN THE DOLLAR FROM 1980 TO 1984

REDUCED THE INFLATION RATE, AS MEASURED BY THE GNP DEFLATOR, BY ABOUT 1 PERCENT PER YEAR BELOW WHAT IT WOULD HAVE BEEN OTHERWISE.

ON THE NEGATIVE SIDE, U.S. FIRMS COMPETING WITH OVERSEAS BUSINESSES HAVE BEEN PUT AT A SEVERE COST DISADVANTAGE. WHEREAS GROWTH IN JOBS IN THE PRIVATE SERVICES SECTOR HAS BEEN QUITE STRONG, MANY MANUFACTURING INDUSTRIES, WHICH TEND TO COMPETE MORE INTERNATIONALLY, HAVE REDUCED THEIR WORK FORCES. THE AGRICULTURAL AND MINING SECTORS ALSO HAVE BEEN HIT HARD.

YEARS OF STRAINS IN THE INDUSTRIAL SECTOR OF OUR ECONOMY HAVE LED TO WIDESPREAD PRESSURES FOR RESTRICTIVE TRADE POLICIES. ALTHOUGH RESPONSIVE TO GENUINE LOCAL CONCERNS, PROTECTIONIST LEGISLATION POSES A THREAT TO OUR ECONOMY AND TO THOSE OF OUR TRADING PARTNERS. ACTIONS IN THIS AREA INEVITABLY WOULD LEAD TO HIGHER INFLATION AND TO RETALIATORY ACTIONS ABROAD.

FINALLY, AN INCREASING DEPENDENCE ON FOREIGN SAVINGS MAKES THE U.S. ECONOMY MORE VULNERABLE TO SUDDEN SHIFTS IN FOREIGN ATTITUDES ABOUT THE DOLLAR. A LESS FAVORABLE ATTITUDE COULD LEAD

TO BOTH A DROP IN THE DOLLAR AND A SHARP RISE IN INTEREST RATES, BESIDES THEIR IMPACT ON HOUSING AND BUSINESS SPENDING AT HOME, HIGHER INTEREST RATES WOULD ADD TO THE BURDENS OF LESS-DEVELOPED COUNTRIES ALREADY TRYING TO COPE WITH LARGE DEBTS.

POLICY INITIATIVES

IN THE PAST SIX MONTHS, DOMESTIC AND INTERNATIONAL POLICY INITIATIVES HAVE REDUCED THE RISKS FOR THE U.S. AND WORLD ECONOMIES THAT I DISCUSSED. LAST SEPTEMBER 22ND, THE GROUP OF FIVE COUNTRIES, WHICH CONSISTS OF THE U.S., JAPAN, THE U.K., FRANCE, AND WEST GERMANY, AGREED TO COORDINATE BETTER THEIR OVERALL ECONOMIC POLICIES IN ORDER TO ENCOURAGE FURTHER ORDERLY DEPRECIATION OF THE DOLLAR, AND TO SUPPORT SUCH COORDINATION WITH FOREIGN EXCHANGE MARKET INTERVENTION WHERE APPROPRIATE.

BETWEEN FEBRUARY 1985 AND THE G-5 AGREEMENT, THE TRADE-WEIGHTED VALUE OF THE DOLLAR FELL BY 12 PERCENT. SINCE THE G-5 AGREEMENT, THE DOLLAR HAS DECLINED A FURTHER 18 PERCENT. A

QUESTION REMAINS, HOWEVER, WHAT REALLY HAS BEEN RESPONSIBLE FOR THE DECLINE IN THE VALUE OF THE DOLLAR? THERE IS CONSIDERABLE EVIDENCE THAT INTERVENTION BY ITSELF DOES NOT HAVE LASTING EFFECTS ON EXCHANGE RATES. MY INTERPRETATION OF THE MOST RECENT EPISODE IS CONSISTENT WITH THAT VIEW. THE INTERVENTION PROBABLY PUSHED THE DOLLAR IN THE DIRECTION THAT WAS DICTATED BY CHANGES IN FUNDAMENTALS.

OF GREAT IMPORTANCE TO THE DOLLAR AND TO INTERNATIONAL IMBALANCES IN GENERAL HAVE BEEN CHANGES IN ECONOMIC POLICIES IN THE UNITED STATES. FIRST, IT BECAME APPARENT IN 1985 THAT THE U.S. ECONOMY WAS IN A PERIOD OF SLUGGISH GROWTH. THIS MEANT THAT THE FEDERAL RESERVE DID NOT NEED TO BE OVERLY CONCERNED THAT THE DECLINING INTEREST RATES OVER THE PAST YEAR AND ONE HALF POSED A THREAT OF RE-IGNITING INFLATION. IN OTHER WORDS, THE FED WAS ABLE TO PROMOTE THE CONTINUATION OF THE ECONOMIC RECOVERY WITHOUT THE RISK OF LOSING ANY GROUND ON INFLATION.

SECOND, THE OUTLOOK FOR REDUCING FEDERAL BUDGET DEFICITS HAS IMPROVED. THE BUDGET RESOLUTION PASSED LAST YEAR MANDATED SIGNIFICANT DEFICIT REDUCTION, AND THIS NEW BUDGET TREND WAS REINFORCED BY THE PASSAGE OF THE LANDMARK GRAMM-RUDMAN-HOLLINGS LEGISLATION LAST DECEMBER. ALTHOUGH THE "ACROSS-THE-BOARD" SPENDING REDUCTION FEATURE OF GRAMM-RUDMAN LEAVES A LOT TO BE DESIRED AS A METHOD OF CHOOSING AMONG ALTERNATIVE GOVERNMENT PROGRAMS, THE LEGISLATION DOES PUT SOME "TEETH" INTO THE CRUCIAL PROCESS OF REDUCING OVERALL SPENDING. OF COURSE, IT IS DIFFICULT TO TELL TO WHAT EXTENT THE LAW ACTUALLY WILL BE IMPLEMENTED, IN PART, BECAUSE ITS CONSTITUTIONALITY IS BEING CHALLENGED IN THE COURTS. BUT NO MATTER WHAT HAPPENS TO THIS PARTICULAR APPROACH TO DEFICIT REDUCTION, IT APPEARS THAT THE TIDE IS TURNING ON THE DEFICIT.

MONETARY POLICY

LAST YEAR, THE MOST PRESSING CONCERN OF MONETARY POLICY WAS TO FACILITATE THE TRANSITION TO MORE MODERATE BUT SUSTAINABLE

RATES OF GROWTH, CONSISTENT WITH GRADUAL DECLINES IN UNEMPLOYMENT, AND AT THE SAME TIME TO MAINTAIN THE PROGRESS THAT HAD BEEN MADE AGAINST INFLATION. THIS "SOFT-LANDING" SCENARIO, AS THE RESEARCH STAFF AT THE SAN FRANCISCO FED LIKES TO CALL IT, HAS THE ADDED ATTRACTION THAT IT OFFERS A REASONABLE CHANCE OF AVOIDING THE SHARP MOVEMENTS IN EXCHANGE RATES AND INTEREST RATES THAT I DISCUSSED EARLIER.

CHOOSING POLICIES THAT SATISFY SO MANY CONSIDERATIONS SIMULTANEOUSLY IS ALWAYS TRICKY, BUT RECENT DEVELOPMENTS MAKE IT EVEN MORE SO THIS YEAR. I REFER IN PARTICULAR TO GRAMM-RUDMAN, THE IMPRESSIVE DECLINE IN THE PRICE OF OIL, AND THE DROP IN THE DOLLAR SINCE FEBRUARY 1985. THESE FACTORS PRESENT ADDITIONAL CHALLENGES FOR MONETARY POLICY BECAUSE IT IS NOT YET POSSIBLE TO GAUGE THEIR FINAL OUTCOME OR, WITH MUCH PRECISION, TO MEASURE THEIR IMPACTS ON THE ECONOMY.

THESE UNCERTAINTIES ARE COMPOUNDED BY THE UNUSUAL BEHAVIOR LAST YEAR OF THE FED'S NARROW MONETARY AGGREGATE, M1, WHICH

CONSISTS OF CURRENCY AND CHECKABLE DEPOSITS. THIS AGGREGATE HAS BEEN A MAJOR INDICATOR USED BY THE FED TO GAUGE THE IMPACT OF MONETARY POLICY ACTIONS ON ECONOMIC ACTIVITY AND INFLATION. BUT LAST YEAR, ITS RELATIONSHIP WITH GNP AND INFLATION SEEMED TO BREAK DOWN -- AT LEAST TEMPORARILY.

THE NEARLY 12 PERCENT GROWTH OF M1 LAST YEAR PUT IT WELL ABOVE ITS TARGET, EVEN AFTER THE TARGET ITSELF WAS REVISED UPWARD AT MID-YEAR. UNDER NORMAL CIRCUMSTANCES, THE INFLATIONARY DANGERS OF SUCH A RAPID RATE OF M1 GROWTH WOULD BE CAUSE FOR CONCERN. BUT THE ACCOMPANYING SHARP DECLINE IN M1'S VELOCITY -- THE RATE AT WHICH MONEY CIRCULATES -- WAS UNUSUAL, RAISING THE QUESTION OF WHETHER M1'S HISTORICAL RELATIONSHIP WITH THE ECONOMY COULD BE RELIED ON.

IN THIS ENVIRONMENT OF HEIGHTENED UNCERTAINTY, THE FED CONCLUDED THAT GROWTH IN M1 ABOVE ITS TARGET RANGE FOR 1985 WOULD BE ACCEPTABLE. THIS UNCERTAINTY CARRIED OVER TO THE CHOICE OF THE 1986 TARGET FOR M1, WHICH WAS LEFT AT A RELATIVELY WIDE 3 TO

8 PERCENT ANNUAL GROWTH RANGE. BY COMPARISON, THE BROADER MONETARY AGGREGATES, M2 AND M3, WERE GIVEN NARROWER 6 TO 9 PERCENT RANGES.

GIVEN INCREASED UNCERTAINTY ABOUT MONEY'S RELATIONSHIP TO THE ECONOMY, AS WELL AS THE UNCERTAINTIES SURROUNDING THE FUTURE COURSE OF FISCAL POLICY, OIL PRICES, AND THE DOLLAR, GROWTH IN THE MONETARY AGGREGATES WILL CONTINUE TO BE INTERPRETED WITHIN THE CONTEXT OF ONGOING DEVELOPMENTS IN THE ECONOMY, IN DOMESTIC CREDIT MARKETS, AND IN FOREIGN EXCHANGE MARKETS. THERE IS NO SIMPLE POLICY RULE THAT WILL WORK IN TODAY'S UNCERTAIN ENVIRONMENT.

ECONOMIC OUTLOOK

LET ME CONCLUDE BY SAYING A FEW WORDS ABOUT THE ECONOMIC OUTLOOK. I EXPECT ABOUT 3 1/2 PERCENT GROWTH IN REAL GNP BETWEEN THE FOURTH QUARTER OF 1985 AND THE FOURTH QUARTER OF 1986. THIS WOULD BE A SIGNIFICANT IMPROVEMENT OVER THE

2 1/4 PERCENT GAIN OF LAST YEAR, AND A VERY IMPRESSIVE PERFORMANCE FOR THE FOURTH YEAR OF A BUSINESS EXPANSION. ECONOMIC GROWTH THIS YEAR SHOULD BE STRONG ENOUGH TO PRODUCE FURTHER INCREASES IN EMPLOYMENT BUT ONLY MODERATE REDUCTIONS IN THE UNEMPLOYMENT RATE.

THE STRENGTHENING OF THE ECONOMY THIS YEAR SHOULD BE SHAPED BY SEVERAL CROSS CURRENTS. A RELATIVELY LOW OPERATING RATE FOR FACTORIES AND WIDESPREAD VACANCIES IN OFFICE SPACE SUGGEST THAT BUSINESS EXPENDITURES FOR PLANT AND EQUIPMENT WILL BE SLUGGISH. IN ADDITION, WEAK GROWTH IN GOVERNMENT SPENDING, DUE IN PART TO THE GRAMM-RUDMAN LEGISLATION, ALSO WILL RESTRAIN OVERALL ECONOMIC GROWTH THIS YEAR. IN ADDITION, PROSPECTS FOR THE AGRICULTURE, ENERGY, AND MINING INDUSTRIES ARE NOT ALL THAT ENCOURAGING.

AT THE SAME TIME, HOWEVER, OTHER SECTORS OF THE ECONOMY ARE LIKELY TO PERFORM WELL. CONSUMER SPENDING SHOULD GROW AT A RESPECTABLE, INFLATION-ADJUSTED RATE OF APPROXIMATELY 3 PERCENT THIS YEAR. THE NEGATIVE EFFECTS ON CONSUMER SPENDING OF HIGH

DEBT LEVELS AND A PUSH BY HOUSEHOLDS TO BUILD UP DEPLETED SAVINGS ARE EXPECTED TO BE MORE THAN OFFSET BY SEVERAL POSITIVE FACTORS. CONSUMER SPENDING WILL BE ENCOURAGED BY FURTHER GAINS IN EMPLOYMENT; BY THE PERSISTENCE OF INTENSE PRICE COMPETITION AMONG RETAILERS; BY THE FAVORABLE EFFECTS ON BORROWING COSTS OF RECENT LARGE DECLINES IN INTEREST RATES; AND BY THE STRONG FAVORABLE WEALTH EFFECTS OF HIGHER BOND AND STOCK PRICES. THE IMPROVED FINANCIAL ENVIRONMENT ALSO SHOULD PRODUCE A ROBUST HOUSING SECTOR AND COULD RESULT IN THE HIGHEST LEVEL OF HOUSING STARTS SINCE 1978.

THE EFFECTS OF THE DEPRECIATION OF THE DOLLAR SHOULD EVENTUALLY GIVE A BOOST TO THE ECONOMY THIS YEAR, AS OUR EXPORTS BECOME MORE COMPETITIVE AND DOMESTIC PRODUCERS ARE BETTER ABLE TO COMPETE WITH IMPORTS. FINALLY, THIS BOOST TO GNP WILL BE ENHANCED BY A MODERATE RESTOCKING OF INVENTORIES.

WITH SOME LUCK, THESE GENERALLY FAVORABLE PROSPECTS FOR THE ECONOMY SHOULD BE ACCOMPANIED BY A HEALING PROCESS IN THE

FINANCIAL SECTOR. AS MENTIONED, THE EXPECTED INCREASE IN PERSONAL SAVINGS AND THE HIGHER PRICES OF FINANCIAL ASSETS SHOULD PRODUCE AN IMPROVEMENT IN HOUSEHOLD BALANCE SHEETS. ALSO, AT TODAY'S INTEREST RATES, THE BUSINESS SECTOR WOULD BE ABLE TO EXTEND THE MATURITY OF ITS EXISTING DEBTS AT THE LOWEST COSTS SEEN IN LONG-TERM MARKETS IN 8 YEARS. PERHAPS MOST SIGNIFICANTLY, THE RECENT SHARP RUN-UP IN STOCK PRICES MAKES EQUITY CAPITAL AN ATTRACTIVE SOURCE OF FUNDS FOR MANY CORPORATIONS FOR THE FIRST TIME IN YEARS.

ON THE INFLATION FRONT, THE EFFECTS OF A DEPRECIATING DOLLAR WILL ULTIMATELY AND INEVITABLY RESULT IN UPWARD PRESSURE ON INFLATION. FOR THE TIME BEING, HOWEVER, THESE PRESSURES SHOULD BE OFFSET BY THE EFFECTS OF DECLINING OIL PRICES. AS A RESULT, INFLATION THIS YEAR SHOULD RECORD A RATE SIMILAR TO THAT OF LAST YEAR.

THIS OPTIMISTIC OUTLOOK SHOULD NOT LEAD US TO LOWER OUR GUARD AGAINST INFLATION. THREE OR FOUR PERCENT INFLATION IS ONLY

ACCEPTABLE IN THE CONTEXT OF RECENT HISTORY AND MUST NOT BECOME A LONG-TERM OBJECTIVE. MOREOVER, SHORTER-TERM DANGERS OF HIGHER INFLATION CANNOT BE DISMISSED WITH IMPUNITY. AS THE ECONOMY MOVES TOWARD A FULLER UTILIZATION OF ITS RESOURCES, WAGE AND PRICE PRESSURES EVENTUALLY WILL DEVELOP. IF THIS TREND IS ACCOMPANIED BY A TURNAROUND IN ENERGY PRICES AND BY THE INFLATIONARY EFFECTS OF A DEPRECIATING DOLLAR, THE TIME WILL COME WHEN THE TASK OF COMBATING INFLATION AGAIN MOVES TO THE FOREGROUND.

IN CONCLUSION, THE OUTLOOK FOR THE ECONOMY IN 1986 IS A POSITIVE ONE. MOREOVER, A VERY PRELIMINARY LOOK AT PROSPECTS FOR 1987 REVEALS NO REASON TO RAISE THE RED FLAG OF RECESSION. HOWEVER, I ALSO THINK THAT THE RANGE OF UNCERTAINTY AROUND THIS OUTLOOK IS VERY HIGH. AN ABILITY TO REACT QUICKLY AND APPROPRIATELY TO UNEXPECTED DEVELOPMENTS MAY TURN OUT TO BE AN ESSENTIAL ELEMENT IN MONETARY POLICY THIS YEAR.