



FEDERAL RESERVE BANK OF SAN FRANCISCO  
Office of the President

**ECONOMIC ACTIVITY  
AND INFLATION IN THE UNITED STATES:  
PROSPECTS AND RISKS**

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CURRENTLY, THERE IS A STRIKING CONTRAST BETWEEN THE CONTINUING SLUGGISH PERFORMANCE OF THE U.S. ECONOMY AND THE MANY SIGNS OF A MORE ROBUST FUTURE. ALTHOUGH THE GROSS NATIONAL PRODUCT ADJUSTED TO REMOVE THE EFFECTS OF INFLATION, OR REAL GNP, HAS GROWN AT AN ANNUAL RATE OF ONLY TWO PERCENT ON AVERAGE OVER THE PAST TWO YEARS, I EXPECT REAL GROWTH TO BE STRONGER IN THE SECOND HALF OF THIS YEAR AND IN 1987.

APART FROM ACTUAL RECESSIONS, THE PERIOD SINCE THE MIDDLE OF 1984 IS THE FIRST EPISODE IN THE POST-WAR ERA IN WHICH GNP GROWTH AS LOW AS TWO PERCENT HAS PERSISTED FOR AS LONG AS TWO YEARS. LARGELY BECAUSE OF THIS SLOW GROWTH, THE CIVILIAN UNEMPLOYMENT RATE HAS BEEN STUCK BETWEEN SEVEN AND SEVEN-AND-A-HALF PERCENT, AND CAPACITY UTILIZATION HAS ACTUALLY DECLINED. BUT, I AM OPTIMISTIC THAT BY THE END OF NEXT YEAR, THE ECONOMY WILL BE OPERATING CLOSER TO FULL EMPLOYMENT OF BOTH LABOR AND CAPITAL.

THIS OUTLOOK FOR HIGHER LEVELS OF OUTPUT AND EMPLOYMENT OBVIOUSLY IS VERY APPEALING. BUT, IN ADDITION TO PROMOTING ECONOMIC GROWTH, THE FED ALSO MUST REMAIN SENSITIVE TO THE NEED TO CONTINUE MAKING PROGRESS TOWARD STABLE PRICES. ONE OF THE THEMES OF MY REMARKS TODAY WILL BE THAT, WITH THE ECONOMY POISED TO ACCELERATE, INFLATION IS A POTENTIAL PROBLEM AND WE MUST REMAIN ALERT TO THIS DANGER.

### THE FUNDAMENTALS

MY OPTIMISM FOR THE REAL ECONOMY REFLECTS IMPROVEMENT IN SEVERAL OF THE FUNDAMENTAL FACTORS AFFECTING REAL GROWTH: SPECIFICALLY, DECLINES IN THE INTERNATIONAL VALUE OF THE DOLLAR, IN INTEREST RATES AND, MOST RECENTLY, IN THE PRICE OF OIL. THESE DEVELOPMENTS, WHICH IN THE CASES OF THE DECLINES IN INTEREST RATES AND THE EXCHANGE RATE GO BACK MORE THAN A YEAR, SUGGEST THAT ECONOMIC GROWTH WILL PICK UP IN THE SECOND HALF OF THIS YEAR AND CONTINUE INTO 1987.

SINCE FEBRUARY OF LAST YEAR, THE INTERNATIONAL VALUE OF THE DOLLAR HAS DECLINED ALMOST THIRTY PERCENT. THIS DROP ENABLES U.S. EXPORTERS TO COMPETE MORE EFFECTIVELY IN MARKETS ABROAD, WHILE FOREIGN PRODUCERS FIND IT MORE DIFFICULT TO COMPETE IN OUR MARKETS. AS WE SELL MORE GOODS AND SERVICES ABROAD AND MEET MORE OF OUR DOMESTIC NEEDS WITH HOME-BUILT PRODUCTS, THE RESULTING REDUCTION IN OUR TRADE DEFICIT WILL CONTRIBUTE TO GNP GROWTH IN THE SECOND HALF OF THIS YEAR AND MORE SIGNIFICANTLY THROUGHOUT NEXT YEAR.

DOMESTIC INTEREST RATES HAVE FALLEN SHARPLY IN THE LAST TWO YEARS. IN JUNE 1984, THE MORTGAGE RATE WAS FOURTEEN-AND-A-HALF PERCENT; NOW IT IS A FAR LOWER TEN-AND-A-HALF PERCENT. YIELDS ON CORPORATE BONDS AND U.S. TREASURY OBLIGATIONS HAVE DECLINED BY SIMILAR AMOUNTS OVER THE SAME PERIOD. MOREOVER, SURVEYS OF BUSINESSMEN'S LONGER RUN EXPECTATIONS OF THE INFLATION RATE SHOW ONLY A RELATIVELY SMALL ONE PERCENT DECLINE FROM THE RATE THEY EXPECTED TWO

YEARS AGO. IN OTHER WORDS, IT APPEARS THAT MOST OF THE REDUCTION IN INTEREST RATES HAS BEEN A DROP IN REAL OR INFLATION-ADJUSTED RATES AND THUS IN THE TRUE EXPECTED COST OF BORROWING FOR BUSINESSES AND HOUSEHOLDS.

THE DECLINE IN MORTGAGE RATES HAS PRODUCED A SIGNIFICANT EXPANSION IN HOME BUILDING. HOWEVER, OWING TO UNUSED CAPACITY IN MANUFACTURING AND HIGH OFFICE VACANCY RATES, THE DECLINE IN LONG-TERM INTEREST RATES HAS NOT YET STIMULATED COMMERCIAL BUILDING AND EQUIPMENT SPENDING. BUT, AS THE ECONOMY EXPANDS AND SALES PROSPECTS IMPROVE, I EXPECT GREATER SPENDING IN THESE AREAS TOO.

SO FAR, THE DECLINE IN THE WORLD PRICE OF OIL SINCE FEBRUARY HAS HAD A NEGATIVE INFLUENCE ON OVERALL ECONOMIC ACTIVITY, AS THE DOMESTIC OIL INDUSTRY AND RELATED ENERGY PRODUCERS HAVE HAD TO COPE WITH REDUCTIONS IN THE PRICES OF THEIR PRODUCTS. BUT LOWER OIL PRICES SHOULD BE BENEFICIAL OVER THE LONG HAUL, SINCE THE U.S. IS A NET OIL IMPORTER.

TO OBTAIN A GIVEN AMOUNT OF IMPORTED OIL WE WILL HAVE TO EXPORT FEWER U.S. PRODUCTS AND THUS HAVE MORE LEFT OVER FOR DOMESTIC USE. LOWER ENERGY PRICES MEAN THAT CONSUMERS AND CORPORATIONS HAVE ADDITIONAL SPENDABLE FUNDS THAT ALREADY ARE ADDING TO THE DEMAND FOR DOMESTIC PRODUCTS.

### OUTLOOK

ALL OF THESE FACTORS POINT TO AN ACCELERATION IN THE ECONOMY BEGINNING SOMETIME IN THE SECOND HALF OF THIS YEAR -- PERHAPS TO GROWTH RATES AS HIGH AS FOUR PERCENT IN THE REMAINDER OF 1986 AND THREE-AND-A-HALF PERCENT NEXT YEAR. THIS FASTER PACE SHOULD BRING THE CIVILIAN UNEMPLOYMENT RATE DOWN TO AROUND SIX-AND-A-HALF PERCENT BY THE END OF 1987.

A GOOD DEAL OF UNCERTAINTY EXISTS CONCERNING WHAT WILL HAPPEN TO INFLATION NEXT YEAR. UNTIL MAY, BOTH PRODUCER AND CONSUMER PRICES HAD BEEN DECLINING THIS YEAR AS THE DRAMATIC DROP IN OIL PRICES FED THROUGH THE ECONOMY. BUT THE SHARP FALL IN THE DOLLAR'S VALUE OVER THE LAST YEAR-AND-A-HALF HAS

BEGUN TO BOOST PRICES AS IMPORTED GOODS HAVE BECOME MORE EXPENSIVE.

HISTORICAL EVIDENCE SUGGESTS THAT SUCH PRICE "SHOCKS" TAKE ABOUT TWO YEARS TO HAVE THEIR FULL EFFECT ON DOMESTIC INFLATION. HOWEVER, THIS TIME AROUND, THE OIL SHOCK SEEMS TO BE FEEDING THROUGH MORE RAPIDLY THAN USUAL, WHEREAS THE EFFECTS OF THE DOLLAR'S DECLINE SEEM SOMEWHAT DELAYED. THUS, WE EXPECT THE OIL SHOCK TO DOMINATE THE NUMBERS FOR THIS YEAR, HOLDING INFLATION TO AROUND TWO-AND-A-HALF PERCENT. BUT NEXT YEAR, THE EFFECTS OF THE DEPRECIATING DOLLAR WILL EXERT A LARGER INFLUENCE AND, AS A RESULT, OVERALL INFLATION IS EXPECTED TO INCREASE TO ABOUT A THREE-AND-A-HALF PERCENT RATE.

#### CHALLENGES TO MONETARY POLICY

I AM CONCERNED THAT WITH THE ECONOMY APPROACHING A FULLER UTILIZATION OF ITS RESOURCES NEXT YEAR, THERE INEVITABLY IS A RISK THAT INFLATIONARY PRESSURES WILL RE-

EMERGE. THUS THE PERIOD AHEAD IS AN ESPECIALLY TRICKY ONE IN THE BATTLE TO ELIMINATE INFLATION. AS USUAL, THE FUNDAMENTAL CHALLENGE FACING MONETARY POLICY IS TO FIND A SUITABLE BALANCE BETWEEN CONCERN FOR THE GROWTH RATE OF ECONOMIC ACTIVITY AND FOR INFLATION. IN FACT, MY OWN VIEW IS THAT WE NOT ONLY SHOULD AVOID LOSING GROUND AGAINST INFLATION, BUT SHOULD CONTINUE OUR EFFORTS TO MAKE FURTHER PROGRESS TOWARD PRICE STABILITY.

LET ME TURN NOW TO SOME SPECIFIC PROBLEMS THAT I SEE FACING THE FED IN REALIZING THIS AGENDA OF SUSTAINING REAL GROWTH WHILE HOLDING DOWN INFLATION. FIRST, A VARIETY OF INDUSTRY-SPECIFIC PROBLEMS PLAGUE THE ECONOMY, ESPECIALLY IN OIL AND AGRICULTURE. SERIOUS THOUGH THESE PROBLEMS ARE, HOWEVER, THEY ARE NOT AMENABLE TO FUNDAMENTAL SOLUTION BY MONETARY POLICY. OUR INSTRUMENTS CANNOT BE DIRECTED ONLY TO SPECIFIC INDUSTRIES OR REGIONS.

THE FED IS SENSITIVE TO DIFFICULTIES FACING PARTICULAR INDUSTRIES, AND IT TRIES TO AVOID EXACERBATING SUCH PROBLEMS. BUT IF WE ATTEMPTED TO SOLVE THE PROBLEMS OF INDIVIDUAL INDUSTRIES WITH GENERAL MONETARY POLICY MEASURES, THE RESULT INEVITABLY WOULD BE TO "OVERHEAT" THE ECONOMY AND GENERATE A RESURGENCE OF INFLATION.

HIGH LEVELS OF DEBT IN SEVERAL KEY SECTORS ALSO ARE A SOURCE OF CONCERN: THE RATIO OF CONSUMER DEBT TO INCOME IS CLOSE TO ITS ALL-TIME HIGH, MANY FARMERS FACE HEAVY DEBT BURDENS, AND MERGERS AND LEVERAGED BUY-OUTS HAVE RAISED THE DEBT/EQUITY RATIO OF THE CORPORATE SECTOR. SOME ANALYSTS SUGGEST THAT THIS ACCUMULATED DEBT MAY CAUSE REDUCED SPENDING AS PEOPLE AND BUSINESSES ATTEMPT TO REBUILD THEIR BALANCE SHEETS. OTHERS ARGUE THAT A DEBT CRISIS IS A POSSIBILITY. SOMETIMES IT IS SUGGESTED THAT THERE MIGHT BE A FUTURE CONFLICT FOR THE FED BETWEEN THE NEED TO RAISE INTEREST RATES TO REDUCE INFLATIONARY PRESSURES, AND THE

CONCERN THAT SUCH ACTIONS WOULD SUBJECT MANY BORROWERS TO SEVERE FINANCIAL STRESS.

ALTHOUGH RISING DEBT BURDENS DO REPRESENT A POTENTIAL PROBLEM FOR THE ECONOMY, THERE ARE MITIGATING FACTORS. THE STRONG UPWARD TRENDS IN THE BOND AND STOCK MARKETS HAVE ADDED SIGNIFICANTLY TO ASSET VALUES AND NET WORTH, THEREBY REDUCING THE DETRIMENTAL EFFECTS OF INCREASED DEBT. IN ADDITION, CORPORATIONS AND HOUSEHOLDS RECENTLY HAVE LENGTHENED THE MATURITY OF THEIR DEBT, THEREBY REDUCING DEBT SERVICING BURDENS.

CHOOSING POLICIES THAT PROMOTE A GRADUAL APPROACH TO FULL EMPLOYMENT AND A FURTHER REDUCTION IN INFLATION, AND AVOID EXACERBATING INDUSTRY-SPECIFIC AND DEBT PROBLEMS, IS ALWAYS TRICKY, BUT SEVERAL FACTORS MAKE IT EVEN MORE SO THIS YEAR AND NEXT. FIRST, IT IS DIFFICULT TO GAUGE THE EFFECT OF FISCAL POLICY ON THE ECONOMY, SINCE THERE ARE UNUSUAL UNCERTAINTIES ON BOTH THE EXPENDITURE AND THE REVENUE SIDES

OF THE FEDERAL GOVERNMENT'S BUDGET. UNCERTAINTIES CONCERNING FEDERAL OUTLAYS WERE INTENSIFIED LAST WEEK WHEN IT WAS REPORTED BY SOME NEWS SOURCES THAT THE U.S. SUPREME COURT HAD VOTED TO UPHOLD A LOWER COURT'S RULING THAT A KEY PROVISION OF THE GRAMM-RUDMAN DEFICIT-REDUCTION LEGISLATION IS UNCONSTITUTIONAL.

IN ADDITION, THE LIKELIHOOD THAT CONGRESS WILL PASS A SIGNIFICANT TAX REFORM PACKAGE THIS YEAR HAS INCREASED SINCE THE SENATE FINANCE COMMITTEE REPORTED OUT A BILL INCORPORATING SIMILAR BASIC PRINCIPLES TO THE HOUSE BILL AND TO THE ADMINISTRATION'S PROPOSAL. THOSE PRINCIPLES, WHICH INVOLVE MOVING TO A MORE EQUITABLE TAX SYSTEM AND ONE THAT INTERFERES LESS WITH PRIVATE ECONOMIC DECISIONS, HOLD CONSIDERABLE APPEAL TO ME. BUT THE EFFECT OF A MAJOR RESTRUCTURING OF THE NATION'S TAX LAWS ON TREASURY REVENUES AND THE FEDERAL DEFICIT IN COMING YEARS IS DIFFICULT TO PREDICT, ESPECIALLY BECAUSE THE SPECIFIC FORM OF THE FINAL

BILL IS NOT YET KNOWN. THUS, TAX REFORM COMPLICATES THE JOB OF THE FED IN FORECASTING THE EFFECTS OF FISCAL POLICY ON THE ECONOMY AND, THEREFORE, IN CHOOSING AN APPROPRIATE MONETARY POLICY IN THE NEAR TERM.

THE UNCERTAINTIES I HAVE DISCUSSED ARE COMPOUNDED BY THE UNUSUAL BEHAVIOR OF THE FED'S NARROW MONETARY AGGREGATE, M1, WHICH CONSISTS OF CURRENCY AND CHECKABLE DEPOSITS. THIS AGGREGATE OFTEN HAS BEEN A SIGNIFICANT INDICATOR USED BY THE FED TO GAUGE THE IMPACT OF MONETARY POLICY ON THE ECONOMY. BUT LAST YEAR AND SO FAR THIS YEAR, ITS RELATIONSHIP WITH GNP AND INFLATION SEEMS TO HAVE BROKEN DOWN.

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. THIS RAPID GROWTH HAS CONTINUED SO FAR THIS YEAR, SO THAT M1 NOW STANDS WELL ABOVE ITS 1986 TARGET. UNDER NORMAL CIRCUMSTANCES, THE INFLATIONARY POTENTIAL OF SUCH RAPID M1 GROWTH WOULD BE CAUSE FOR ALARM.

BUT THE ACCOMPANYING SHARP DECLINE IN M1'S VELOCITY --THE RATE AT WHICH MONEY CIRCULATES -- IS UNUSUAL, PROVIDING EVIDENCE THAT M1'S HISTORICAL RELATIONSHIP WITH THE ECONOMY CANNOT BE RELIED ON. MOREOVER, THE POSSIBILITY THAT M1 MAY BE PROVIDING A FALSE SIGNAL SEEMS TO BE CONFIRMED BY THE FED'S BROADER MONETARY AGGREGATES, M2 AND M3. THESE AGGREGATES HAVE GROWN MORE SLOWLY THAN M1 AND SEEM TO HAVE EXHIBITED MORE NORMAL RELATIONSHIPS WITH GNP LAST YEAR AND SO FAR THIS YEAR.

BUT HAVING SAID THIS, I ALSO THINK IT WOULD NOT BE WISE TO TOTALLY IGNORE M1, GIVEN ITS HISTORICALLY CLOSE, LONG-RUN RELATION WITH PRICES. UNCERTAINTIES ABOUT M1'S RELIABILITY COME AT AN ESPECIALLY INOPPORTUNE TIME BECAUSE THE OIL-PRICE AND EXCHANGE-RATE SHOCKS TO PRICES MAKE IT VERY DIFFICULT TO MEASURE THE UNDERLYING RATE OF INFLATION. ALTHOUGH IT CLEARLY WOULD BE INAPPROPRIATE TO CLAMP DOWN ON THE ECONOMY RIGHT NOW OUT OF FEAR OF INFLATION, IT WOULD BE EQUALLY

INAPPROPRIATE TO DISREGARD THE RISK THAT AN INFLATION PROBLEM MIGHT RE-EMERGE IF WE ARE NOT CAREFUL.

THUS, CONDUCTING EFFECTIVE MONETARY POLICY OVER THE REMAINDER OF THIS YEAR AND INTO NEXT YEAR WILL REQUIRE FINDING THE PROPER BALANCE BETWEEN CONCERN FOR THE RATE OF ECONOMIC ACTIVITY AND FOR INFLATION. OF COURSE, THE FED HAS FACED THE CHALLENGE OF FINDING SUCH A BALANCE MANY TIMES BEFORE. OVER THE PAST TWO YEARS, IT WAS APPROPRIATE TO EMPHASIZE KEEPING THE ECONOMIC EXPANSION GOING, WHILE CONTINUING TO WATCH INFLATION FOR ANY SIGNS OF TROUBLE. HOWEVER, AS THE ECONOMY BEGINS TO ACCELERATE LATER THIS YEAR, THE BALANCE WILL NEED TO SHIFT TOWARD MORE EMPHASIS ON THE RISK OF RE-EMERGING INFLATION. IN THIS WAY, IT SHOULD BE POSSIBLE TO PROMOTE SUSTAINABLE ECONOMIC GROWTH, WHILE AT THE SAME TIME ENSURING THAT CONTINUED PROGRESS IS MADE TOWARD PRICE STABILITY.