

**FEDERAL RESERVE BANK
OF SAN FRANCISCO**

**OFFICE OF
THE PRESIDENT**

A PERSPECTIVE ON THE ECONOMIC OUTLOOK

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GOOD MORNING LADIES AND GENTLEMEN. IT CERTAINLY IS A PLEASURE TO BE HERE IN LOS ANGELES AND TO BE ABLE TO SHARE SOME THOUGHTS WITH YOU ON THE OUTLOOK FOR THE ECONOMY. BUT I ALSO WANT TO MENTION A FEW UNCERTAINTIES THAT ARE CLOUDING THE CRYSTAL BALL. FINALLY, I'D LIKE TO MENTION VERY BRIEFLY SOME OF THE CHALLENGES TO MONETARY POLICY PRESENTED BY THE ECONOMIC OUTLOOK AND BY THOSE TROUBLING UNCERTAINTIES.

AS I'M SURE MOST OF YOU KNOW, ECONOMIC GROWTH IN THE UNITED STATES HAS SLOWED RECENTLY, RAISING CONCERN IN MANY QUARTERS THAT THE CURRENT EXPANSION IS COMING TO AN END. AFTER GROWING AT AN ACCEPTABLE, BUT UNSPECTACULAR, 3 PERCENT RATE DURING 1985, GROWTH IN THE ECONOMY'S OUTPUT DROPPED TO JUST OVER 2 PERCENT IN THE FIRST HALF OF THIS YEAR AND $2\frac{1}{2}$ PERCENT IN THE THIRD QUARTER.

OVER THE PAST YEAR AND A-HALF, THE U.S. UNEMPLOYMENT RATE HAS BEEN STUCK BETWEEN $6\frac{3}{4}$ AND $7\frac{1}{4}$ PERCENT -- SOMEWHAT HIGHER THAN THE 6 TO $6\frac{1}{2}$ PERCENT THAT

APPEARS TO REPRESENT "FULL" EMPLOYMENT IN THE U.S. ECONOMY. MOREOVER, CAPACITY UTILIZATION IN MANUFACTURING ACTUALLY HAS DECLINED RATHER SUBSTANTIALLY. CALIFORNIA ALSO HAS SEEN SOME SLOWING, ALTHOUGH ECONOMIC GROWTH IN THE STATE CONTINUES TO OUTSTRIP THAT IN THE U.S.

DESPITE THESE RELATIVELY LACKLUSTER NATIONAL STATISTICS, I BELIEVE THAT A PICK-UP IN THE U.S. ECONOMY IS IN THE OFFING. OVER THE NEXT YEAR, I THINK THAT THE U.S. ECONOMY WILL GROW AT AROUND A 3 PERCENT RATE, AND THAT SOME PROGRESS WILL BE MADE TOWARDS ACHIEVING A FULLER EMPLOYMENT OF BOTH LABOR AND CAPITAL. CALIFORNIA PROBABLY WILL CONTINUE TO HAVE A FASTER RATE OF OVERALL ECONOMIC GROWTH THAN THE U.S., BUT BECAUSE OUR LABOR FORCE ALSO TENDS TO GROW VERY QUICKLY AS WELL, THE STATE'S UNEMPLOYMENT RATE IN 1987 IS LIKELY TO REMAIN FAIRLY CLOSE TO THE NATION'S.

THE OUTLOOK FOR BOTH THE U.S. AND THE CALIFORNIA

ECONOMIES IS SUBJECT TO A NUMBER OF MAJOR UNCERTAINTIES, PERHAPS MORE THAN USUAL. AND JUST AS THESE UNCERTAINTIES CREATE DIFFICULTIES FOR THOSE OF YOU MAKING BUSINESS PLANS FOR THE COMING YEAR, THEY ALSO MAKE THE FED'S JOB OF FORECASTING ECONOMIC DEVELOPMENTS AND OF DESIGNING MONETARY POLICY MORE DIFFICULT.

THE FUNDAMENTALS

THERE ARE TWO FUNDAMENTAL FACTORS THAT LEAD ME TO MY FAIRLY OPTIMISTIC OUTLOOK FOR THE ECONOMY NEXT YEAR.

FIRST, THE INTERNATIONAL VALUE OF THE DOLLAR HAS DROPPED SUBSTANTIALLY WITH RESPECT TO MAJOR CURRENCIES SINCE FEBRUARY OF LAST YEAR. THIS DROP ENABLES U.S. EXPORTERS TO COMPETE MORE EFFECTIVELY IN MARKETS ABROAD, WHILE FOREIGN PRODUCERS FIND IT MORE DIFFICULT TO SELL THEIR GOODS AND SERVICES IN OUR MARKETS. I BELIEVE OUR TRADE DEFICIT IS BEGINNING TO IMPROVE AND THAT IT SHOULD CONTRIBUTE SIGNIFICANTLY TO ECONOMIC GROWTH NEXT YEAR.

SECOND, INTEREST RATES IN THE UNITED STATES HAVE

FALLEN SHARPLY THIS YEAR, CONTINUING A TREND THAT BEGAN IN THE LATTER HALF OF 1984. LOWER INTEREST RATES PROVIDE SUPPORT TO THE INTEREST-SENSITIVE SECTORS OF THE ECONOMY, INCLUDING SPENDING FOR PLANT AND EQUIPMENT, CONSUMER DURABLES, AND RESIDENTIAL STRUCTURES. THIS DECLINE IN INTEREST RATES HAS BEEN FACILITATED AND ENCOURAGED BY FEDERAL RESERVE MONETARY POLICY. FOUR TIMES THIS YEAR, THE DISCOUNT RATE HAS BEEN CUT, FOR A TOTAL REDUCTION OF 2 PERCENTAGE POINTS. LOWER INTEREST RATES HAVE BEEN AN IMPORTANT FACTOR IN KEEPING THE ECONOMIC EXPANSION GOING INTO WHAT IS NOW ITS FOURTH YEAR.

MORTGAGE RATES HAVE BEEN A PART OF THE GENERAL FALL IN RATES, PRODUCING SIGNIFICANT EXPANSION IN HOMEBUILDING. SOUTHERN CALIFORNIA HAS BEEN IN THE FOREFRONT OF THIS EXPANSION. SO FAR THIS YEAR, THE LOS ANGELES REGION HAS RECORDED AN INCREASE IN THE NUMBER OF RESIDENTIAL BUILDING PERMITS OF ABOUT 14 PERCENT OVER LAST YEAR. WITH THE SUPPORT OF LOWER INTEREST RATES, CONSTRUCTION OF SINGLE-

FAMILY HOUSES IN THE U.S. AND SOUTHERN CALIFORNIA SHOULD CONTINUE AT A HEALTHY RATE THROUGH THE END OF NEXT YEAR. HOWEVER, PASSAGE OF THE TAX REFORM BILL ALREADY HAS BEGUN TO DISCOURAGE NEW MULTI-FAMILY CONSTRUCTION, WHICH HAS BEEN A PARTICULARLY STRONG SEGMENT OF THE LOS ANGELES AREA HOUSING MARKET, AND I WOULD NOT BE SURPRISED TO SEE MULTI-FAMILY STARTS DOWN SUBSTANTIALLY IN 1987 COMPARED WITH THIS YEAR.

THE DECLINE IN LONG-TERM INTEREST RATES HAS NOT YET STIMULATED BUSINESS SPENDING FOR CONSTRUCTION AND EQUIPMENT. THIS PROBABLY IS A RESULT OF LARGE UNUSED CAPACITY, DISLOCATIONS IN THE OIL AND GAS INDUSTRIES, AND HIGH OFFICE VACANCY RATES. HOWEVER, I EXPECT MORE ACTIVITY OF THIS TYPE THROUGHOUT THE COUNTRY AS THE ECONOMY BEGINS TO EXPAND MORE RAPIDLY AND SALES PROSPECTS IMPROVE. SO, GENERALLY I'M OPTIMISTIC. BUT MY OPTIMISM IS TEMPERED BY SEVERAL AREAS OF UNCERTAINTY.

AREAS OF UNCERTAINTY

ONE MAJOR UNCERTAINTY IS HOW MUCH OF AN IMPROVEMENT IN OUR TRADE DEFICIT ACTUALLY WILL RESULT FROM THE DECLINE IN THE DOLLAR. DATA THROUGH THE SECOND QUARTER DIDN'T GIVE ANY SIGNS THAT THE TRADE DEFICIT HAD BEGUN TO IMPROVE, EVEN THOUGH THE DOLLAR HAD BEEN DEPRECIATING FOR MORE THAN A YEAR.

RECENTLY RELEASED STATISTICS FOR THE THIRD QUARTER PROVIDE MORE ROOM FOR OPTIMISM. ALTHOUGH THE INCREASE IN EXPORTS OF GOODS AND SERVICES CONTINUED TO FALL SHORT OF THE INCREASE IN IMPORTS, A GOOD PART OF OUR IMPORTS WERE OIL. IF WE EXCLUDE THESE HIGHER OIL IMPORTS, WHICH ARE PRICED IN DOLLARS AND THUS ARE NOT VERY RESPONSIVE TO EXCHANGE RATES, OUR FOREIGN BALANCE ACTUALLY IMPROVED IN THE THIRD QUARTER. THIS IS ENCOURAGING, BUT WE SHOULD NOT FORGET THAT OUR TRADE DEFICIT STILL IS FAR LARGER THAN WE EXPECTED, GIVEN THE HUGE DROP IN THE DOLLAR.

ONE REASON FOR A DELAYED IMPROVEMENT IN THE TRADE BALANCE APPEARS TO BE THAT EXCHANGE RATE CHANGES AREN'T

BEING PASSED THROUGH TO IMPORT PRICES AS QUICKLY AS THEY USED TO BE. THE PRICE OF IMPORTED GOODS OTHER THAN PETROLEUM DIDN'T PICK UP SIGNIFICANTLY RELATIVE TO DOMESTIC PRICES UNTIL THE SECOND QUARTER OF 1986, MORE THAN A YEAR AFTER THE DOLLAR BEGAN ITS SHARP DEPRECIATION.

A SECOND REASON FOR THIS DELAYED IMPROVEMENT IS THAT THE DOLLAR HAS DROPPED A LOT LESS AGAINST THE CURRENCIES OF SOME OF OUR TRADING PARTNERS THAN IT HAS AGAINST THOSE OF OTHER PARTNERS, SUCH AS JAPAN AND THE MAJOR EUROPEAN COUNTRIES. IN SOME CASES THE DOLLAR HAS ACTUALLY RISEN AGAINST THE CURRENCIES OF SOME TRADING PARTNERS -- CANADA AND A FEW OF THE SO-CALLED NEWLY INDUSTRIALIZED COUNTRIES, OR NICs FOR SHORT. THE LARGE DROP IN THE DOLLAR WE ALL HAVE READ ABOUT PROBABLY IS SOMEWHAT OVERSTATED, BECAUSE MOST OF THE COMMONLY CITED EXCHANGE-RATE STATISTICS EXCLUDE NICs.

TRADE WITH THESE COUNTRIES HAS BECOME VERY SIGNIFICANT, ESPECIALLY FOR THE SOUTHERN CALIFORNIA AREA, BECAUSE OF THIS REGION'S CLOSE AND EXPANDING TIES WITH THE PACIFIC RIM AND

MEXICO. THE SIX MOST IMPORTANT NICs --SOUTH KOREA, HONG KONG, SINGAPORE, TAIWAN, MEXICO AND BRAZIL -- ACCOUNTED FOR FULLY 36 BILLION DOLLARS OF THE TOTAL U.S. TRADE DEFICIT OF 149 BILLION DOLLARS IN 1985. AND SINCE EXCHANGE RATES WITH THESE COUNTRIES HAVEN'T CHANGED MUCH IN RECENT YEARS, TRADE DEFICITS WITH THEM MAY NOT IMPROVE MUCH IN THE YEAR AHEAD.

FISCAL POLICY

ANOTHER MAJOR SOURCE OF UNCERTAINTY IN THE OUTLOOK IS FISCAL POLICY. THE EXTENT TO WHICH THE GRAMM-RUDMAN DEFICIT-REDUCTION LEGISLATION ACTUALLY WILL LEAD TO LOWER FEDERAL SPENDING HAS BEEN A SOURCE OF SPECULATION IN THE ECONOMIC OUTLOOK FOR SOME TIME. ON PAPER, THE CONGRESS OVERSHOT THE 144 BILLION DOLLAR GRAMM-RUDMAN TARGET FOR THE DEFICIT IN FISCAL YEAR 1987 BY THE TEN BILLION DOLLARS THAT THE LEGISLATION ALLOWED. HOWEVER, BECAUSE OF THE PECULIAR BUDGET ARITHMETIC PERMITTED BY THE LEGISLATION, THE ACTUAL DEFICIT FOR 1987, INSTEAD OF BEING 154 BILLION DOLLARS, IS LIKELY TO REACH 180 BILLION DOLLARS. STILL, THAT

WOULD BE A SUBSTANTIAL REDUCTION FROM AN ESTIMATED DEFICIT OF 221 BILLION DOLLARS FOR FISCAL 1986. A REDUCTION IN THE DEFICIT OF THIS MAGNITUDE WOULD GREATLY SLOW THE FEDERAL GOVERNMENT'S CONTRIBUTION TO ECONOMIC GROWTH NEXT YEAR, OFFSETTING A LARGE PART OF THE EXPANSIONARY EFFECT OF TODAY'S WEAKER DOLLAR AND LOWER INTEREST RATES.

SOME INDUSTRIES COULD BE PARTICULARLY AFFECTED BY THE SLOWDOWN IN GOVERNMENT SPENDING. FOR EXAMPLE, DEFENSE CUTBACKS WILL LIKELY CUT GROWTH PROSPECTS FOR SOUTHERN CALIFORNIA'S AREOSPACE INDUSTRY, ALTHOUGH THE IMPACT COULD BE DELAYED UNTIL 1988 OR LATER BECAUSE OF DEFENSE ORDERS ALREADY IN THE PIPELINE. BUT, AS WITH THE TRADE BALANCE, WE FACE A GOOD MEASURE OF UNCERTAINTY ABOUT HOW MUCH THE BUDGET DEFICIT REALLY WILL DECLINE. I DON'T THINK WE'LL HAVE A GOOD FIX ON THAT UNTIL ABOUT THE TIME WE FIND OUT THE WINNER OF THE 1987 WORLD SERIES--A BIT LATE FOR FORECASTING PURPOSES.

ON THE REVENUE SIDE OF THE BUDGET, THE TAX REFORM BILL

ALSO RAISES UNCERTAINTIES ABOUT THE FUTURE PERFORMANCE OF THE ECONOMY. ASIDE FROM QUESTIONS CONCERNING THE EFFECT OF THE TAX CHANGE ON THE ECONOMY'S LONG-RUN GROWTH RATE, THERE ARE MORE IMMEDIATE QUESTIONS CONCERNING ITS IMPACT ON NEXT YEAR. THE COST OF CAPITAL FOR BUSINESS WILL BE RAISED SIGNIFICANTLY BY THE ELIMINATION OF THE INVESTMENT TAX CREDIT, THE LENGTHENING OF SERVICE LIVES FOR DEPRECIATION, AND THE ELIMINATION OF THE TAX ADVANTAGES TO LIMITED BUSINESS PARTNERSHIPS. ALTHOUGH THE REDUCTION IN THE CORPORATE TAX RATE WILL PROVIDE SOME OFFSET, THE NET EFFECT STILL IS LIKELY TO BE UNFAVORABLE FOR BUSINESS INVESTMENT IN 1987.

EVENTUALLY, THIS NEGATIVE EFFECT ON GROWTH WILL TEND TO BE OFFSET BY HIGHER HOUSEHOLD SPENDING IN RESPONSE TO LOWER PERSONAL INCOME TAXES. HOWEVER, BECAUSE THE TAX REFORMS FOR INDIVIDUALS ARE "STAGGERED" -- WITH TAXPAYERS LOSING SOME PERSONAL DEDUCTIONS BEFORE THEY ENJOY LOWER TAX RATES AND HIGHER PERSONAL EXEMPTIONS -- THE MAJOR STIMULUS TO PERSONAL CONSUMPTION PROBABLY WON'T COME UNTIL 1988.

THUS, THIS YEAR AND NEXT, TAX REFORM SHOULD HAVE A NET NEGATIVE IMPACT ON GNP, LOWERING REAL GROWTH BY CLOSE TO 1/2 PERCENT. BUT, ONCE AGAIN, IT'S VERY DIFFICULT TO BE ON SOLID GROUND PREDICTING THE EXACT IMPACT, GIVEN THE TREMENDOUS NUMBER OF TAX CHANGES BEING MADE SIMULTANEOUSLY.

OIL PRICES

A FINAL MAJOR SOURCE OF UNCERTAINTY ABOUT FUTURE ECONOMIC GROWTH IS THE EXTENT AND DURATION OF DISLOCATION IN THE OIL INDUSTRY CAUSED BY THE DROP IN THE PRICE OF OIL THIS YEAR. PROSPECTS FOR SOME IMPROVEMENT IN THIS AREA WERE ENHANCED WHEN THE NEW OPEC PRODUCTION QUOTAS CAUSED THE PRICE OF OIL TO JUMP TO THE 14 TO 16 DOLLAR PER BARREL RANGE, COMPARED WITH JUST OVER 11 DOLLARS PER BARREL IN LATE JULY. IF THE PRICE OF OIL STAYS AT AROUND ITS PRESENT LEVEL, THE MAJOR DISLOCATIONS IN THE OIL AND GAS INDUSTRIES PROBABLY ARE BEHIND US, AND WE SHOULD SEE SOME RECOVERY IN EMPLOYMENT AND CAPITAL SPENDING LATER THIS YEAR AND THROUGHOUT NEXT YEAR. OF COURSE, THIS ASSESSMENT COULD

TURN OUT TO BE OVERLY OPTIMISTIC FOR THESE INDUSTRIES, SINCE THE OPEC AGREEMENT TO LIMIT PRODUCTION IS VERY FRAGILE.

UNCERTAINTY ABOUT THE FUTURE PRICE OF OIL ALSO RAISES A QUESTION ABOUT WHAT WILL HAPPEN TO INFLATION NEXT YEAR. THE DRAMATIC DROP IN OIL PRICES THIS YEAR CAUSED BOTH CONSUMER AND PRODUCER PRICES ACTUALLY TO FALL FOR THE FIRST FOUR MONTHS OF THIS YEAR, AND SHOULD HELP TO KEEP INFLATION TO AROUND 2 1/2 PERCENT FOR ALL OF 1986. THIS WOULD BE THE LOWEST RATE OF INFLATION, AS MEASURED BY THE GNP DELATOR, REGISTERED SINCE 1967. ALTHOUGH THIS IS VERY ENCOURAGING WE SHOULD NOT FORGET THAT, WITH THE OIL-PRICE "SHOCK", INFLATION THIS YEAR PROBABLY HAS BEEN BELOW ITS LONG-RUN, OR UNDERLYING RATE.

NEXT YEAR, IF THE PRICE OF OIL STAYS AT ITS PRESENT LEVEL, AND THUS DOES NOT PROVIDE ANOTHER DOWNWARD THRUST TO PRICES, THE WEAKER DOLLAR FEEDING THROUGH IN THE FORM OF HIGHER COSTS OF IMPORTS WILL BE THE DOMINANT INFLUENCE ON PRICE MOVEMENTS. IN THIS CASE, INFLATION COULD RISE BY AS

MUCH AS A FULL PERCENTAGE POINT OVER ITS EXPECTED RATE OF INCREASE THIS YEAR. HOWEVER, A COLLAPSE OF THE RECENT OPEC AGREEMENT AND CONSEQUENT FALL IN OIL PRICES AGAIN COULD PUSH INFLATION BELOW ITS UNDERLYING RATE NEXT YEAR. SO, ALONG WITH A LOT OF OIL, OPEC SUPPLIES US WITH A LOT OF "IFS" FOR OUR INFLATION FORECAST.

CHALLENGES TO MONETARY POLICY

THESE UNCERTAINTIES IN THE OUTLOOK -- THE TRADE BALANCE, FISCAL POLICY, AND OIL PRICES -- PROVIDE FORMIDABLE CHALLENGES FOR MONETARY POLICY. THE ECONOMY'S FAILURE TO SHOW CLEAR SIGNS OF SUSTAINED, HEALTHY GROWTH, MAKES IT TEMPTING TO ARGUE THAT, FOR SAFETY'S SAKE, MONETARY POLICY SHOULD LEAN FURTHER TOWARD BOOSTING PRODUCTION.

CURRENT STATISTICS, HOWEVER, CAN BE A MISLEADING GUIDE. IT TAKES TIME FOR THE EFFECTS OF MONETARY POLICY TO WORK THEIR WAY THROUGH THE ECONOMY. COMPLICATING MATTERS EVEN FURTHER, THERE ARE LAGS IN RECEIVING RELIABLE DATA ON WHAT ACTUALLY HAS HAPPENED TO IMPORTANT INDICATORS SUCH AS REAL

GNP AND THE BALANCE OF TRADE. SOMETIMES WE DON'T REALLY KNOW WHERE WE'VE BEEN UNTIL WE'RE ALREADY SOMEWHERE ELSE. GIVEN THESE DIFFICULTIES, A POLICY OF CONTINUALLY LOWERING INTEREST RATES UNTIL THERE IS UNAMBIGUOUS EVIDENCE OF AN IMPACT ON THE ECONOMY RUNS A REAL RISK -- A RISK THAT POLICY INADVERTENTLY WILL BECOME TOO STIMULATIVE, RAISING THE SPECTER OF REEMERGING INFLATIONARY PRESSURES.

BY MY CALCULATIONS, THE EASING OF MONETARY POLICY OVER THE PAST YEAR SHOULD BE CONSISTENT WITH THE ECONOMY GROWING AT A HEALTHY, SUSTAINABLE PACE NEXT YEAR. BUT ALTHOUGH THIS OUTLOOK IS APPEALING, WE MUST RECOGNIZE THAT WITH THE ECONOMY POISED TO MOVE TOWARD A FULLER UTILIZATION OF ITS RESOURCES, INFLATIONARY PRESSURES COULD RE-EMERGE. CALIFORNIANS SHOULD BE PARTICULARLY SENSITIVE TO THIS PROSPECT, CONSUMER PRICES HAVE BEEN RISING SIGNIFICANTLY FASTER IN THE STATE THAN IN THE NATION AS A WHOLE OVER THE PAST TWO YEARS.

THIS INFLATIONARY RISK IS HEIGHTENED IN MY MIND BY THE RECENT BEHAVIOR OF THE MONETARY AGGREGATES, WHICH WE AT

THE FED USE AS INDICATORS OF THE FUTURE IMPACT OF MONETARY POLICY. THE BROADER MONETARY AGGREGATES, M2 AND M3, BOTH ARE NEAR THE UPPER BOUNDARIES OF THEIR TARGET RANGES THIS YEAR.

THUS, ALTHOUGH FEDERAL RESERVE POLICY ACTIONS MUST REFLECT CONCERN ABOUT THE CURRENT SLUGGISHNESS OF THE ECONOMY, WE MUST BALANCE THIS CONCERN AGAINST THE RISK THAT TOO MUCH EASE MIGHT LEAD TO PROBLEMS WITH INFLATION IN THE YEARS TO COME. BALANCING THESE CONCERNS IS THE WAY WE AT THE FED CAN DO OUR JOB BEST -- PROMOTING SUSTAINABLE ECONOMIC GROWTH, WHILE ENSURING THAT CONTINUED PROGRESS IS MADE TOWARD PRICE STABILITY.

