FEDERAL RESERVE BANK
OF SAN FRANCISCO

OFFICE OF
THE PRESIDENT

MONETARY POLICY IN THE NEW YEAR

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Good afternoon ladies and gentlemen. It's my pleasure to have this opportunity to give you my views on monetary policy in the new year.

The Federal Reserve is facing an unusually wide array of conflicting policy challenges. There is a risk that the economic expansion, which now ranks as the second longest since World War II, will become a casualty of the stock-market crash. Fortunately, we have not seen major signs of weakness to date. At the same time, with the economy in the range of full employment and growing strongly through the end of last year, we face the risk of higher future inflation. Finally, there is the rapid depreciation of the dollar, which has transmitted uncertainty and volatility to other financial markets in this country and around the world, and strained our relations with our trading partners.

I hope that by the end of my remarks this afternoon, you will have a better appreciation for what lies ahead for the U.S. economy this year, and for the issues that the Federal Reserve must confront in designing policies to avoid the pitfalls in our economic future.

SETTING THE STAGE

Last year's developments set the stage for the outlook and policy issues facing the Federal Reserve this year. Accordingly, I would like to take a few moments to review 1987 so that you will see my view of 1988 in its proper perspective.

In many respects, 1987 was a good year for the U.S. economy. Output expanded at a robust pace, faster than can be sustained in the long term. The unemployment rate dropped from 6 3/4 percent at the beginning of the year to around 5 3/4 percent in December, which by most estimates is in the range of full employment.

Unfortunately, inflation picked up last year. According to estimates based on the most comprehensive measure of inflation, prices rose by around 4 percent versus 2 1/4 percent in 1986. Most of this higher inflation resulted from special factors such as declines in the exchange rate of the dollar and increases in the price of oil, and not from underlying wage increases. Wage inflation remained quite moderate last year, although it did increase as the year went along.

With the economy in the range of full employment and expanding rapidly, and with the dollar depreciating, the threat of a resurgence in inflationary pressures was a major concern for monetary policy, at least until the stock-market crash. Thus the Federal Reserve increased pressure on the reserve positions of depository institutions in the spring and raised the discount rate in September.

The foreign-exchange value of the dollar was highly volatile last year, and on balance, lost nearly one fourth of its purchasing power against the yen and nearly one fifth against the mark. In the spring and again in the fall, declines in the dollar were accompanied by sharp increases in U.S. interest rates. In part, these interest-rate responses reflected the market's concerns about the inflationary impact of the declining dollar.

The market also seemed worried that foreigners might begin to view the U.S. as a less desirable place in which to lend funds. This development could have unpleasant consequences for the U.S. economy. Our federal government needs to borrow large amounts of funds to finance its huge budget deficit. In addition, U.S. consumers and corporations are saving only a small share of their incomes.

As a consequence of this ongoing imbalance between the demand for credit and the available domestic supply, we have become highly dependent on foreign credit. Should a rapidly depreciating dollar make foreigners less willing to lend in this country, our interest rates could jump quite sharply. In addition, a rapidly falling dollar slows growth in the economies of our trading partners by reducing their exports and increasing their imports. Thus although the decline in the dollar to date will help eliminate our huge trade deficit, a sharp depreciation in the future could raise problems for the U.S. and for our major trading partners.

The group-of-seven, or G-7 countries -- including Canada, France, Great Britain, Italy, Japan, West Germany, and the U.S. -- agreed in February to limit exchange-rate fluctuations through coordination of their respective monetary and fiscal policies, and at times through exchange-market intervention. Japan and Germany took steps to ease their monetary and fiscal policies. The Federal Reserve also was in a position to cushion the dollar's fall, since as I mentioned earlier, concerns about higher U.S. inflation motivated somewhat tighter monetary policies.

All of this changed abruptly when the stock market fell in October. The sudden loss of wealth, and the potentially adverse effects on consumer and business confidence, raised the specter of recession. The Federal Reserve immediately moved to provide the liquidity needs of the economic and financial system, and interest rates declined. Lower interest rates undoubtedly have contributed to the rather sharp drop in the dollar since then. However, in the face of a clear threat to the U.S. economy, concerns about a rapid depreciation of the dollar had to be put on hold.

PROSPECTS FOR 1988

The performance of the economy this year will depend on how last year's divergent trends play themselves out. The major impetus to growth is likely to come from an improvement in the foreign trade deficit: in inflation-adjusted terms, exports should grow much faster than imports in response to the depreciation of the dollar. Thus although the rapidly falling dollar has raised many uncertainties in the financial markets, it should boost growth in our economy and help reduce our trade deficit.

In contrast, domestic spending is likely to grow only modestly, at best. To some extent, this expected weakness reflects a small reduction in government spending and somewhat higher private saving rates, and therefore bodes well for the health of the economy in the long run. In fact it would be preferable, in my view, if the imbalance in our federal budget were eliminated more rapidly than now seems likely. Although the deficit declined from $221 billion in fiscal year 1986 to $148 billion last year, part of the reduction was the result of a one-time surge in capital gains taxes at the end of 1988 in anticipation of tax reform, and of various other one-time factors such as sales of federal assets. Without such factors, we would expect the deficit this year to rise to about $170 billion. The Congress and Administration agreed to pursue legislation requiring a $25 to $30 billion reduction in the deficit for fiscal year 1988. The proposed package is controversial, however, and we will have to wait and see if it results in true deficit reduction near the stated magnitude.

The stock-market decline could be another important factor in slowing domestic spending this year. Even before the crash, I expected to see sluggish consumer spending as saving rates moved up toward more normal levels. The loss of wealth by consumers associated with lower stock prices should reduce further their purchases of goods and services. According to normal historical relationships, the loss of wealth associated with a stock-market decline of the magnitude we've experienced should lower consumer spending by about 1 percent this year. I must caution you that this estimate is highly tentative because it's extremely difficult to gauge the effect of the stock-market crash on consumer confidence. Surveys taken thus far provide room for optimism. They show some decline in confidence, but nothing dramatic.

Lower stock prices also will make it more expensive for businesses to raise money by selling equity, and a loss of confidence about the business outlook would depress spending further. However, surveys thus far haven't turned up a significantly lower level of business confidence, and the actual increase in the cost of capital associated with the stock-market fall is surprisingly small.

Another factor mitigates the depressing effects of the stock-market crash on domestic spending. As investors fled the stock market, they favored the credit markets, thus driving down U.S. interest rates. Since the crash, long-term interest rates have fallen by around 1 percent. This development should boost spending by businesses on investment projects and by consumers on durable goods, thereby offsetting part of the depressing effect of the interest rate increases prior to October.

Economic data released since October have failed to show convincing signs of a slowdown related to stock-market developments. In fact, employment and industrial production through December show that the economy has been affected very little so far. Of course, one cannot rule out the possibility that stock-market effects will hit with longer lags than in the past, but overall, the threat of recession relating to the events of late last year is dwindling.

Taking all of these prospective developments into account, I expect economic growth of around 2 1/2 percent this year after adjusting for inflation. If the economy grows at this pace, the inflation rate, as measured by the broad-based GNP price index, is likely to average around 3 1/2 to 4 percent through the end of this year, down slightly from the pace of 1987. Given that the labor market is now fairly tight, with the civilian unemployment rate around 6 percent and expected to remain there this year, there's good reason to expect that wages will begin to rise at a faster pace. Prices in the U.S. also will continue to be pushed up by the lower value of the dollar, which is raising the cost of imported goods.

The expected small decline in inflation this year as compared to 1987 comes entirely from the recent drop in the price of oil, and the current indications that it may remain relatively low in the foreseeable future. However, the importance of this factor introduces a high degree of uncertainty into the inflation outlook, since we have experienced many surprising, and sharp, turn arounds in oil prices in the past.

Another element of risk in the forecast is that Congress may enact protectionist legislation this year. Although prospects for improvement in the trade deficit are good, certain regions and industries still are being affected adversely. However, protectionist legislation would be a mistake. It would reduce growth in the economy overall, and would add significantly to the rate of inflation.

I do not take much comfort in the possibility that inflation will be somewhat lower this year than it was in 1987. The expected respite depends on oil prices remaining at or below current levels, which by no means is guaranteed. But more importantly, lower oil costs may end up masking the effects of upward pressure on wages coming from the relatively tight labor markets in this country. Wage pressures on inflation tend to be highly persistent. Thus the cost in terms of lost employment and production of reducing higher wage inflation, once it got going, would be substantial, delaying progress toward ultimately achieving price stability.

MONETARY POLICY ISSUES

The combination of underlying inflationary pressures together with the risk of a pronounced slowing in economic activity, presents the Federal Reserve with an unusual challenge in 1988. Based upon my view of the economic outlook, it is likely that monetary policy will need to go through a gradual, and very careful, transition from focusing primary concern on the recessionary impacts of the stock-market crash to a resumption of its earlier concern that the economy was expanding too rapidly at a time of full employment.

The basic problems prior to the stock-market crash are still with us: the federal budget deficit still is huge, and the personal saving rate still is low. At the same time, I expect to see considerable improvement this year in the trade deficit, which would mean a reduction in the supply of foreign credit to U.S. financial markets. In the face of a continuing need to finance large budget deficits without a larger supply of domestic saving, reduced foreign credit most likely would put upward pressure on U.S. interest rates.

Of course, the Federal Reserve could attempt to offset this pressure through easier monetary policies. This is not an acceptable approach, however, since it inevitably would lead to higher inflation. Thus unless a solution soon is found to the federal government's budget problem, or Americans begin to save a larger share of their incomes, the underlying pressures in the economy will be for higher inflation.

This risk was raised last year when the economy moved close to full employment. And, as the evidence continues to accumulate that the stock-market drop is not slowing the economy significantly, the day moves closer when monetary policy will need to refocus its immediate concern on controlling inflation. Of course, any such transition must be implemented gradually, and carefully, to make sure that possible depressing effects of the stock market really have run their course.

If it does become clear that the stock market is not going to depress the economy significantly, it will be possible to bring domestic policies into better alignment with international considerations. As I already have described, over most of last year, monetary policy was able to pursue its goal of keeping inflation under control, while at the same time, these policies most likely cushioned the decline in the dollar and thus fostered better coordination of our policies with those of the other G-7 countries.

However, the most important contribution the Federal Reserve can make to the health of the international economic system is to focus primarily on the domestic economy by promoting the continuation of the expansion in the U.S. at low rates of inflation. Over time, it is important that the economy move toward a rate of inflation nearer to zero than four percent. I hope that my remarks this afternoon have shed some light on how the conflicting trends in the economy will need to be balanced this year in designing policies to achieve these important goals.