

**FEDERAL RESERVE BANK
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**OFFICE OF
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**Monetary Policy and the Economy:
What Lies Ahead?**

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Good afternoon, ladies and gentlemen. I appreciate this opportunity to talk to you today about what lies ahead for Federal Reserve monetary policy and the U.S. economy. I'd like to address three topics today: first, a review of the economy and monetary policy last year; second, the Federal Reserve's plans for monetary policy through the end of this year; and third, my outlook for the economy in 1988.

Where We've Been

Since it's difficult to know where we're going without knowing where we've been, I'd like to review what happened in the U.S. economy in 1987. By a lot of measures, the economy did quite well. The nation's production of goods and services grew by 4 percent. The unemployment rate declined from 6-3/4 to 5-3/4 percent. Three million new jobs were added. Finally, we regained some of our lost competitiveness internationally; U.S. manufactures and even agricultural products increasingly found a welcome in markets abroad.

The surge in exports of cotton, fruits, and nuts was a blessing to the Central Valley, as you know. These developments arrested the slide in land prices and helped to reduce farmers' debt burdens for the first time in several years.

Certainly these are accomplishments to celebrate. Yet there also was a growing sense of uneasiness about the staying power of the current expansion, now the second longest since World War II. The stock market crash in October made this concern all the more real. Now, six months later, it's troubling that the causes of the crash still are not well understood. Some studies pin blame on portfolio insurance and program trading; others point to the breakdown of the order and market-making systems in both the stock and futures markets; still others blame fundamental weaknesses in the U.S. economy -- the federal budget deficit, the trade deficit, and our excessive reliance on foreign capital.

Whatever the causes, Americans' greatest fear -- economic collapse -- proved unfounded. The economy, in fact, turned in an unexpectedly strong performance through the end of the year, and this strength raised a concern of its own. The economy approached "full employment," making continued growth at 1987's rapid pace a recipe for higher inflation in years ahead.

And, in fact, inflation did increase during the year, from 1.2 percent in 1986 to 4.4 percent (as measured by the Consumer Price Index). Much of last year's rise in inflation could be chalked up to declines in the dollar and increases in oil prices. Most worrisome, however, was evidence that by the end of the year labor markets were tight and many industries were running at full capacity and then some. In other words, underlying inflationary pressures could start to swell again.

Developments in foreign-exchange markets also played a crucial role in 1987. On balance, the dollar lost nearly one-fourth of its purchasing power against the Japanese yen and nearly one-fifth against the West German mark. The lower dollar

enhanced the prospect for an improvement in the U.S. trade deficit in 1988. However, in the spring and again in the fall, sharp increases in U.S. interest rates accompanied declines in the dollar. To some extent, these higher interest rates reflected concern that a lower dollar would spell higher prices of goods imported into this country, and thus more inflation in the future.

This relationship between a declining dollar and rising interest rates also reflected concerns about our dependence on foreign credit. Our low private saving rate and huge federal budget deficit have forced us to rely on funds from abroad to finance investment spending. Without such foreign funds, we would have seen considerably lower private investment in plant and equipment, which is so important for our future economic growth. When the dollar falls, financial market participants fear that foreigners will become less eager to lend funds in this country, and as a consequence, U.S. interest rates are bid up.

In light of all these concerns, monetary policy had to chart a difficult course in 1987. Until October, the Federal Open Market Committee, or FOMC, adopted a policy aimed at restraining inflationary pressures by reining in economic growth to a more sustainable pace. Interest rates rose over the first three quarters of 1987 and growth in the monetary aggregates was sluggish.

But policy had to change in October when the stock market crashed. The sudden loss of wealth, and the potential for a precipitous decline in consumer and business confidence, raised the specter of recession -- or worse. The focus of the FOMC quickly shifted to meeting the immediate liquidity needs of the financial and economic system. Interest rates dropped sharply. The dollar also declined, but more gradually. In the face of the clear threat to the U.S. economy, concerns about the declining dollar had to be put on hold. In fact, signs of further weakness in the economy prompted the Fed to ease monetary policy again in January of this year.

Monetary Policy Plans for 1988

Fortunately, developments in the economy since the stock-market crash suggest that the threat of recession has diminished. Of course, we will continue to monitor the economy for any sign of danger. But I believe that it is time for policy once again to focus its primary efforts on achieving longer-run goals. We must renew our efforts to move towards greater price stability by bringing the inflation rate closer to zero.

After all, the basic problems prior to the crash still are with us: both the federal budget deficit and the trade imbalance still are huge. And although the personal saving rate has risen somewhat since the stock market crash, it still is low by historical standards. Unless the budget problem is resolved soon, or Americans begin to save a much larger share of their incomes, the underlying pressures in the economy will be towards higher inflation.

Unfortunately, the Fed does not have the power to resolve the budget, saving, and trade imbalances. But it can -- and must -- resist the resultant inflationary pressures. Inflation does nothing to solve our underlying problems. Worse, it stunts economic growth by increasing uncertainty, discouraging saving, and interfering with the efficient operation of our market pricing system.

Thus the Fed will seek in 1988 to move towards greater price stability while sustaining the economic expansion. To do this, the FOMC reduced its target ranges for the monetary aggregates in 1988. For the M2 and M3 aggregates, which include most highly liquid forms of wealth, the growth rate ranges are 4 to 8 percent. Reflecting our goal of disinflation, the midpoints of these ranges are one percentage point below last year's 5-1/2 to 8-1/2 percent ranges.

At the same time, we have widened by one percentage point the spread between the upper and lower bounds of the ranges. The four percentage point range reflects a concern that although they're still useful, the monetary aggregates have become less reliable indicators than they once were. Financial deregulation, innovation, and technological change have altered the nature of the aggregates, making them less reliable yardsticks; the relationship between money growth and subsequent developments in inflation and economic activity does not track as well as it once did.

Working with less reliable yardsticks makes the Fed's job more difficult. This problem has motivated research in academia, as well as within the Federal Reserve System, to identify alternative policy tools. There are many alternatives being discussed. For example, the Fed could target a commodity price index, follow a gold standard, or target an alternative definition of money. But unfortunately, in my view, no single indicator -- or, for that matter, no small collection of indicators -- is reliable enough to be used as the primary focus of policy at this time. The potential yardsticks I have mentioned do contain some information about future economic developments. Thus they can be, and are, used in conjunction with a wide variety of other indicators of economic activity and inflation, including domestic and international financial developments.

Where We're Going

We all know that monetary policy cannot control the economy with any great degree of precision. Likewise, where the economy and inflation go this year cannot be known with a high level of certainty. In my view, we are likely to see moderate real GNP growth for the year as a whole around 2-1/2 percent. This growth rate is considerably slower than 1987's unsustainable 4 percent pace, but such a slowdown is desirable from the standpoint of keeping inflation under control.

The engine for growth in 1988 likely will be an improvement in our trade deficit. After registering a modest improvement last year, I expect the trade imbalance to shrink substantially in 1988. Improved price competitiveness

resulting from the dollar's decline should sustain rapid growth in American exports. To date, the dollar's decline has not brought about a significant slowdown in our appetite for imports. However, 1988 should be the year in which we finally see that slowdown in imports in response to higher prices for these products. In this regard, it would be a great mistake to try to restrict imports by enacting protectionist trade laws. Such an approach could end the current economic expansion and, in any event, would raise prices in the U.S. without conferring any real benefits on exporters.

Although the stock market crash had smaller effects on the economy than expected, it did restrain spending on consumer goods to some extent, and as a consequence, the personal saving rate will be somewhat higher in 1988 than it was last year. Thus two of the imbalances in the U.S. economy -- the trade deficit and the low private saving rate -- should improve in 1988.

Unfortunately, prospects for improvement in the third imbalance -- the federal budget deficit -- are not as good. The \$147 billion estimate for fiscal year 1988 released by the Administration may be optimistic. By most estimates, the deficit actually could worsen slightly in 1988 from its \$150 billion level in fiscal year 1987. Moreover, the mandatory Gramm-Rudman cuts now are based only on the Administration's deficit forecast, which currently shows an overly optimistic figure of \$130 billion for fiscal year 1989. In contrast, the projections of the Congressional Budget Office, which are no longer binding for Gramm-Rudman-triggered budget cuts, show a far larger \$177 billion dollar deficit. This change in the Gramm-Rudman rules does not bode well for deficit reduction next year.

The expected slowdown in economic growth this year is likely to mean a small increase in the civilian unemployment rate from its current 5-1/2 percent rate. Of course, high unemployment areas like Fresno still have the capacity to register strong employment gains even if the national unemployment rate rises slightly. Employment gains, in fact, are likely in the Central Valley because of continued improvement in trade and agriculture.

Inflation this year is unlikely to rise above, and could even fall slightly below, last year's four percent rate (as measured by the broad GNP price index). However, I do not take any comfort in this prospect. Inflation in the 3-1/2 to 4 percent range is too high. Moreover, if domestic energy prices were to rise significantly above current levels, inflation for the year easily could rise above last year's rate. In any event, prices of imports likely will rise substantially as a result of the dollar's drop.

More ominously, I see the potential for a buildup in underlying inflationary pressures. With the economy in the range of full employment, we run the risk of a significant increase in wage inflation, which would be difficult to reverse once it had gained momentum. Unless wage inflation is kept under control, we could see 3-1/2 to 4 percent inflation this year turn into significantly higher rates in 1989 and beyond.

The Fed's task is to resist these pressures. Fortunately, now that the specter of the stock-market crash has diminished, we can once again focus on our number-one job of gradually moving the economy toward price stability.