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Remarks by

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Chairman, Board of Governors of the Federal Reserve System

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It's always a pleasure to visit the Reserve Banks and meet with the directors and other individuals who have a particularly sensitive insight for what is happening in different regions of the U S. economy. Certainly, we in the System benefit greatly from the input--and sometimes constructive criticism--that we receive from business and community leaders on occasions such as this.

The directors of our Federal Reserve Banks and branches provide a continuous flow of first-hand information on key developments in their communities and sectors of the economy and complement the economic research efforts of the Banks and the Board. Their task is to see that the Fed does not spend its time talking to itself, but instead that it listens to what the public is saying. All of us deeply appreciate the involvement and dedication of our directors and the important contributions they make in our efforts to attain the nation's economic goals.

1987 was, in many respects, a good year for the economy. Real gross national product rose nearly 4 percent over the course of the year, job growth totaled 3 million, and the unemployment rate declined to 5-3/4 percent, its lowest level of the current decade The Twelfth Federal Reserve District shared in last year's gains. Employment increased sharply in the district this past year as unemployment fell; in California, the unemployment rate has averaged around 5-1/4 percent during the last three months and, despite a slight rise in February, was down nearly a percentage point from a year ago.

It was especially encouraging this past year to observe, in both the national economy and in the Twelfth District, a pick-up in sectors that had lagged earlier in the expansion. Buoyed by rising exports and a pickup in capital spending, manufacturing production surged 5-1/2 percent over the twelve months of 1987, as capacity utilization rose to its highest level in nearly eight years. Gains were also evident in oil extraction, agriculture, and mining. Copper mining, an important business in some parts of the Twelfth District, had its best year in a long time, reflecting both a strengthening of demand and the extensive efforts that have been made in recent years to cut costs and boost productivity. The lumber business, another of the Twelfth District's bellwether industries, has benefited greatly from rising exports.

To be sure, 1987 was not an unblemished success. Inflation, which had dropped sharply in 1986, increased in 1987, owing to the bounce-back in oil prices and to the effects of the dollar's decline on prices of imported goods and their domestic substitutes. Concerns that these one-time price changes might trigger a more pronounced and more deeply-rooted upswing in inflation persisted into the fall, surfacing, at one time or another, in the form of upward pressures on commodity prices or rising long-term interest rates. Under these conditions, further declines in the exchange value of the dollar added to the general uncertainty regarding the prospects for inflation.

The focus of concerns shifted abruptly in mid-October when the stock market crashed. Through the first eight months of the year, a strong bull market had pushed share values to record highs, but those gains were fully reversed in the ensuing decline, which culminated in the October crash. The collapse created strains on the financial markets, erased a huge amount of household wealth, and raised the possibility of a significant retrenchment by households and businesses.

Since the crash, the incoming economic data have provided a mixed picture. A buildup in business inventories in the fourth quarter indicated that firms might need to adjust production early this year and that growth of real GNP might slow for a time. However, payroll employment, while volatile from month to month, has continued to rise at a healthy pace recently, and new orders remain strong, indicating little pressure to liquidate inventories.

Other indicators, on balance, seem to be pointing to further expansion this year. Although the financial markets still are displaying some nervousness, the situation has calmed considerably since October. Interest rates have come down noticeably since last fall, and exchange rate pressures have moderated. In addition, consumer confidence appears to have stabilized in the past couple of months, export prospects remain favorable, and capital goods orders have been strong. On the whole, the chances appear reasonably good for maintaining the current expansion through another year. In the Federal Reserve's semi-annual report to Congress last month, a large majority of the members of the Federal Open Market Committee and other Reserve Bank presidents forecasted growth of real GNP of about 2 to 2-1/2 percent over the four quarters of 1988. Growth of this magnitude would be a slowdown from the 1987 pace, but appears close to what the economy is capable of achieving on a long-run basis.

With respect to inflation, price increases picked up considerably in some markets in 1987. However, the recent data suggest that upward price pressures are not accumulating; and in some markets--oil, for example--declines have surfaced anew early this year. More generally, business and labor still seem to be exercising a considerable degree of restraint in their wage and price-setting behavior, and bottlenecks are not a serious problem at the present time. Should the FOMC's forecasts for moderate growth of real GNP over the coming year prevail, this situation is not likely to change much. Indeed, the FOMC central tendency forecasts that we reported to Congress point to a 1988 rise in prices, as measured by the GNP deflator, of about 3-1/4 to 3-3/4 percent--not significantly different from the 1987 pace.

The near-term prospects for real GNP growth and inflation thus look reasonably encouraging. At the same time, we should not be complacent about the nation's economic future. For several years now, our longer-run economic prospects have been clouded by two related problems--the federal budget deficit and the trade deficit. Although the nation has made some genuine progress in coming to grips with those problems, we still have a long way to go --and the road ahead could be bumpy at times.

As you know, our nation's external balance deteriorated substantially in the first half of the 1980s, as a rising import volume outpaced export growth by a considerable margin. The causes of this growing imbalance were complex, but its effects on consumers and businesses were relatively clear. Consumers benefitted from having access to a broad range of good-quality imports, while the producing sectors that are heavily affected by foreign trade suffered a loss of market share, both domestically and worldwide. In manufacturing, which accounts for nearly two-thirds of our exports, production was sluggish, layoffs mounted, and pressures for protectionism rose Agriculture also suffered as the export boom of the 1970s turned into the export bust of the 1980s. Overall, from mid-1980 to the summer of 1986, real net exports of goods and services fell by an amount equal to 6 percent of real GNP.

Fortunately, the situation is looking up for our producers. In volume terms, our external sector has been improving and accounted for nearly half a percentage point of GNP growth over the four quarters of 1987. As I noted earlier, manufacturing growth was especially robust last year, and the current backlog of orders suggests that factory output should be well-maintained over the near-term. Agricultural exports also strengthened, after several years of decline.

A major portion of the swing back toward external balance still lies ahead, and while that continued adjustment will yield benefits for our economy, it also has the potential to cause some problems. When real exports bottomed out in the summer of 1986, the nation's total spending for goods and services, including inventory investment, exceeded domestic production by about 4-1/4 percent, a gap unprecedented for the postwar period. By the fourth quarter of last year, that gap had shrunk, but only to around 3-1/2 percent of real GNP.

The manner in which that remaining gap is closed will shape key elements of our overall economic performance over the next few years. In particular, as part of the move back toward external balance, export growth could place stronger demands on a domestic resource base that already is operating at high levels of utilization in some areas. To date, however, lead times on the deliveries of newly-ordered production materials remain moderate, implying for the moment little pressure from capacity restraints.

A necessary step in smoothing the adjustment process is for the federal government to continue making progress in reducing its deficit. Throughout most of the postwar period, gross private domestic saving and investment were roughly in balance, federal budget deficits were small, at least by today's standards, and the U.S. showed a positive--and gradually increasing--net foreign investment position. In the 1980s, the pattern changed dramatically, as total domestic saving fell well below investment, reflecting not only the enormous federal deficits, but also a large drop in the private saving rate.

That gap between domestic saving and investment has been filled by capital inflows from abroad. But this is neither a satisfactory nor a sustainable solution over the longer run. Indeed, although the widely anticipated improvement in the nation's current account will provide considerable benefit to the economy, it also will result in diminished capital inflows to the United States.

Conceivably the falloff in foreign capital flows to the U.S. could be offset by a rise in private saving. However, the determinants of private saving are not well understood, and we would be foolish to rely on a spontaneous rise in private saving. Moreover, despite numerous initiatives, public policy appears to have had little effect on total private saving. Instead, the effect of those initiatives has been to shift saving from one pile to another, without much impact on the total. In the absence of a pick-up in private saving, the only way to overcome our shortfall of aggregate domestic saving and still maintain an adequate rate of capital formation is through sizable reductions in budget deficits. Such steps are essential if we are to avoid greater pressures on financial and foreign exchange markets.

The achievement of meaningful deficit reduction undoubtedly will require that some hard decisions be made. The adoption of the Gramm-Rudman-Hollings approach, and its reaffirmation last year, highlight all too vividly the extraordinary difficulty of making such choices. There are no easy answers or magic formulas. Nonetheless, economic logic and historical experience can provide a framework for analyzing the range of possible options.

I suspect, for example, that in the long run there are upside limits to the share of income that can be taxed. For several decades, the overall federal tax bite has been fairly flat, at a bit less than 20 percent of GNP, and under current tax laws will remain in this range into the 1990s. This stability over time is not a coincidence, but is indicative of the public's aversion to rising tax burdens, as was evident in the tax resistance movement of the 1970s and the tax cuts of the 1980s. Of course, no one likes higher taxes, but I also sense a more sophisticated awareness of the disincentives and economic inefficiencies that seem to grow disproportionately along with the size of the tax burden.

This does not mean that revenue changes should be dismissed out of hand. But on the whole, deficit-reduction efforts must of necessity focus on the expenditure side of the budget. Indeed, relying on higher taxes to close the deficit carries with it the risk that expenditures also will be raised, and that the resulting deficit improvement will be small.

I do not underestimate the difficulty of cutting federal spending. Several rounds of deficit-reduction efforts already have taken care of the easy cuts, and, partly as a result, the composition of the budget has shifted toward those categories that are less amenable to control, at least in the short run. Moreover, spending on many of these remaining programs--particularly the entitlement programs--will be under upward pressure in coming years, because of the shifting age distribution of the population.

In these circumstances, controlling spending will demand a willingness to take bold, controversial actions. The payoff to such actions over the long-run, however, will be a substantially better economic performance than we would otherwise experience.

Overall, I am reasonably optimistic about our prospects for negotiating our way through the difficulties posed by the trade deficit and the budget deficit. The improvement in our real trade volumes over the past year, together with the budget-cutting actions that already have been taken, clearly are steps in the right direction, upon which future progress can be built.

Critical to our continued progress is keeping inflation pressures under control. In this regard, monetary policy must maintain, as a long-run objective, establishing reasonable price stability; and during the current period in particular, we cannot allow the price level adjustments associated with the restoration of external balance to set off a renewed inflation process.

Fortunately, the public remains alert to the dangers of inflation, and I sense that there still is a deep reservoir of support for policies to keep inflation in check.

Other changes that have taken place also are constructive for the inflation outlook. Business and labor realize, for example, that they now are competing in a tough international arena and that the way to succeed in that arena is boosting productivity and keeping prices competitive.

There will be some difficulties ahead. However, given firm public support for policies to keep inflation down and to progress further in reducing the federal budget deficit, I have to feel relatively optimistic about the longer-run prospects for price stability and American economic prospects.