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PROSPECTS FOR THE ECONOMY IN 1987

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The current cyclical expansion is now fifty months old. By that it is the second longest peacetime expansion on record. At the same time, we have managed to bring down inflation from double digit rates at the beginning of the decade to roughly 2 percent at the present time. Considering that stagflation was the economic malaise besetting the country only six years ago this is indeed no mean accomplishment.

I would like to argue today that there is every reason to assume that we will continue to make progress in the foreseeable future.

As is always the case, economic growth has slowed somewhat as the expansion has matured. At the present time GNP is rising at a rate of approximately 2 1/2 percent.

The current upswing has also been marked by a rapid expansion in employment opportunities and at

the present time the employment rate of the US population is at a record high. Nonetheless, due to the fact that new persons entered the labor force and the population continued to grow, the unemployment rate last year unfortunately did not fall much below the current 7 percent level. Similarly, capacity utilization rates have not improved in the latter phase of the expansion.

In addition, despite the continued cyclical expansion the economy still suffers from sizeable imbalances. This is true for various regions in the United States, different industries, and most importantly, the imbalance in our trade account and the Federal budget.

As I will discuss in greater detail, it is my view that the performance of the economy in 1987 should be better than it was in 1986. In particular, we will make considerable progress in reducing the existing imbalances and thereby lay the foundation for a further expansion in future years as well.

Consumer Spending Continues to Increase

The American consumer has been the mainspring of the current expansion. The performance of the

consumption sector will be critical to the outlook for 1987.

In assessing the outlook for consumption several points about household financial positions should be kept in mind. First of all, the rate of increase in consumption spending in 1985 and 1986 considerably outstripped income growth, thereby pushing the personal savings rate to its lowest level since 1949. As a matter of fact, consumption increased so rapidly that in absolute terms the amount of additional consumption spending exceeded the increase in GNP during most of 1985 and 1986.

Second, households were able to support these sizeable consumption increases by incurring record levels of new debt. However, the increases in debt were in the aggregate more than offset by advances in asset values -- especially capital gains on stocks and long-term bonds -- leaving the overall net worth position of the household sector relative to income at the highest level since the late 1960s. As we enter 1987 the latest surge in the stock market is pushing household net worth even higher.

Third, in addition to the rise in net worth household financial positions in 1987 will also be

helped by tax reform which should add roughly \$15 to \$20 billion to after-tax disposable income. Effective January 1, most Americans received an increase in take home pay due to the lower tax rates.

One question that will influence the outlook for consumer spending is to what extent households will feel that despite the rise in after-tax and asset values they need to rebuild their savings and to reduce their debt service burden. That is, to what extent might liquidity constraints or at least liquidity concerns become relevant this year.

Another factor affecting consumer spending will be the effect of the decline in the value of the dollar on consumer prices and purchasing power. Historical experience would lead us to expect that the decline in the value of the dollar that has taken place during the last two years should add roughly one percent to the prices paid by the American consumers. So far this affect has been rather subdued because foreign manufacturers have elected to cut their margins in order to preserve their market shares in the important American market. This clearly reduced the impact of the slide in the value of the dollar on prices.

The dollar related loss in purchasing power will be magnified due to the fact that the 1986 decline in oil prices, which boosted real income significantly last year, is not likely to be repeated in 1987. Indeed, in light of recent developments, oil prices may dampen real income growth this year.

On balance, it is my view that liquidity constraints should not be a significant impediment to aggregate consumption spending in 1987. In general, household financial positions should be a relatively neutral force. While tax reform represents an expansionary force, I would expect the effect of the decline in the value of the dollar to cut somewhat into the growth of real disposable personal income. Thus, although consumption should continue to expand this year, the pace is likely to be less robust than in the last two years.

Investment Spending Subdued

Turning to investment, it is clear that business investment in new equipment and structures was quite disappointing in 1986. Even after adjusting for the collapse of oil and gas well drilling, which fell by 50 percent during the first part of 1986, real business investment declined about 1 1/2 percent last year.

Looking to 1987 most indicators point to little if any rebound in overall investment spending activity.

For one, surveys of anticipated plant and equipment spending indicate virtually no planned increase in outlays.

Second, there is little need for business to expand their facilities. The margin of unused capacity in the industrial sector continues to hover around 20 percent, while vacancy rates for office buildings are at record levels in many cities. Finally, for many industries and most types of structures and equipment, tax reform will have an adverse effect on investment demand.

Despite these negatives I suspect that we will see some improvement in capital spending in 1987. The key reason for this is the desire by US firms to modernize their facilities so as to enhance their productivity and to improve their competitiveness internationally. I would like to stress that the successful implementation of such productivity increases is an absolute necessity if we are to make progress in reconquering foreign markets.

Fed Accommodated Increased Demand for Money

Turning to monetary policy it is fair to say that it has not been easy to judge the appropriate monetary policy stance due to the sharp fluctuations in velocity that we experienced recently. While a fall in velocity or an increase in the demand for money should be expected as a result of the lower inflation rate, the extent to which people wish to rebuild their cash balances is by no means clear. There is no historical experience to guide us as to how much of a catchup demand for cash balances exists due to the sharp reduction in the inflation rate.

The problem has been complicated by the financial deregulation process that has been underway during the last few years. The fact that interest rates can now be paid on transaction balances has obviously made them much more attractive as a temporary store of value. In addition, we observe a relatively flat yield curve at the present time. As a result, many people have rebuilt their cash balances.

At year end, additional special factors were at work that increased temporarily the demand for money. It can be expected that many of these special factors will be reversed and that the positions

will be unwound soon.

In this environment monetary policy must be guided not only by the monetary aggregates but also by paying close attention to a wide range of economic and financial indicators.

Given these considerations the Federal Reserve has accommodated the rapid increase in the demand for money while encouraging declines in interest rates through reductions in the discount rate.

Let me emphasize again that the prime focus of monetary policy must continue to be the establishment and maintenance of a stable financial environment within which the economic and financial markets can operate. Monetary policy can do little to reduce the sectoral imbalances in the economy.

Greater Balance in the Budget and the Trade Sector

As I indicated earlier, two of the critical problems facing the economy these days are the imbalances in our Federal budget and our external accounts. These two imbalances, of course, are closely interrelated.

The Administration is projecting a deficit of \$173 billion in the fiscal year 1987. This is a \$50 billion reduction from the deficit experienced last year.

But most importantly, the growth rate in real Federal spending is now less than 1 percent and therefore there is hope that further progress will be made in reducing the size of the deficit.

Nonetheless, the 1987 deficit is still roughly 25 percent larger than the total amount of personal savings expected for this year. In other words, even if all of our personal saving is used to finance the Federal deficit there still will be a shortfall of some \$30 to \$40 billion.

However, it is also fair to mention that the state and local budgets are running a considerable surplus which helps to finance the Federal deficit.

As we all know, the shortfall in domestic saving is made up by borrowing from abroad. Thus an important element in getting our current account deficit under control is to get the Federal deficit under control.

But there is also another side of the coin. Frequently, we hear fears expressed that foreign capital inflows into the US will be reduced. Clearly, we cannot have both foreign capital inflows and a return to balance in the trade accounts. One is the mirror image of the other.

If foreigners buy less US securities, they must be purchasing more goods and services from us. This will result in a multiple increase in our own GNP. The additional national income will also generate a substantial increase in Federal tax receipts and that in turn will contribute to a reduction in the budget deficit. Maybe matters are not as dire as they look on first sight.

As we look to 1987 and beyond it is my view that we will see a move toward greater balance between Federal outlays and revenues. As I mentioned before this would be a positive factor in sustaining the recovery.

Greater balance will be achieved in the foreign trade sector as American manufacturers become more competitive versus foreign producers. In foreign markets American manufacturers will also no longer be disadvantaged due to high exchange rates.

Clearly it is necessary to keep domestic costs under control in these times of adjustment. Businesses have to continue to trim costs, reduce waste and inefficiencies in their operations, and enhance the productivity of labor and capital so that they can gain market share.

The Expansion Will Continue

While uncertainties continue to cloud the outlook for 1987, there are a number of positive signs that make me confident that we are in a position to extend the current expansion for the foreseeable future.

I can assure you that we at the Federal Reserve will do our best to provide a stable financial and monetary environment to make this continuation of the recovery possible.