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UNITED STATES ECONOMIC OUTLOOK

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We are convening at an appropriate time to assess the outlook for the U.S. economy. At present there is a considerable divergence of views regarding the economic prospect. Some analysts are forecasting a recession, while others see considerable inflationary pressures on the horizon. The true pessimists see both recession and inflation ahead and call for a renewed period of stagflation.

Being of an optimistic bent, I am of the view that the current expansion will be sustained and that we will make progress in attaining price stability. Today, I would like to share with you the reasons for this optimism. I will focus first on the domestic front and then turn to the external sector. I will conclude by commenting on the current direction of monetary policy.

THE INFLATIONARY THREAT TO THE EXPANSION

By most broad measures the performance of the U.S. economy in this expansion has been impressive. Since 1983, real growth has averaged 4.2 percent, inflation as measured by the CPI has averaged 3.5 percent, and the unemployment rate has been cut in half. Not only is this record remarkable by our own historical standards, but it compares very favorably with that of other countries.

But now we have arrived at a juncture, where progress will be more difficult to make and where the room for maneuver in policy making will be more closely circumscribed.

At the present time, inflation is the factor most likely to endanger the sustainability of the expansion. If inflationary forces were to take hold, we as a nation would eventually have to choose between ever more inflation or a recession to wring out the inflationary momentum. In such a situation, the adoption of an inflationary route would eventually destroy business confidence and thereby bring about the recession anyhow. Stagflation might well result under such circumstances.

Fortunately, we are not yet faced by such dismal choices, but neither do we have a lot of policy latitude and margin for mistakes. High capacity utilization, low unemployment, some exogenous inflationary impulses, and the existing large trade and budget deficits limit the range of choices available to us.

THE PROPER POLICY MIX

Under these circumstances, the composition of economic growth becomes very important. To lay the foundation for future economic growth, new investment is needed. This new investment has to be financed, and hence there is a need to restrain private consumption and governmental spending. Restraining governmental spending will also help to reduce the fiscal imbalance and is therefore desirable in its own right. At the same time, we should continue to export vigorously to reduce our trade deficit, which in turn will lessen our dependence on foreign capital inflows. In addition, a tight monetary policy is needed to prevent an increase in inflationary pressures. That is the overall game plan. Let me now elaborate a bit on how to put this plan into action.

INVESTMENT GROWTH CONTINUES

In order to lay the foundation for future sustainable growth without running the danger of reigniting inflationary pressures, it is necessary to invest resources to expand our production potential. This means that both private and public consumption must be reduced so that a larger pool of savings will be available to finance the investment. The need for capital formation is even more pressing in an environment of capacity bottlenecks and relative labor scarcity. Thus, investment is crucial to an expansion of our production possibilities.

The trends in investment are encouraging. Business fixed investment has been one of the more dynamic areas of activity in recent years. Helped by strong demand, healthy corporate profits, and near capacity operating rates, fixed investment grew about 7 percent during each of the last two years. Investment in producers' durables and equipment has been even more noteworthy, amounting to almost 10 percent over the same period. It would be unrealistic to expect this strength to continue with the same vigor in the future and some deceleration may be expected. However, surveys of planned plant and equipment expenditures still point to a respectable performance.

In export-oriented and import-competing industries there is particular need for further capacity expansion. Overall, the improved international competitiveness of American industry as well as long-term supply and demand fundamentals indicate that there is a need for more investment in plant and equipment.

In order to promote more investment we must take further strides in improving the general business climate. In this decade, the relaxation of legal and regulatory constraints and tax reform have been significant positive factors. But more can be done to reduce the incentive distorting effects of taxation. In this regard, the elimination of double taxation of dividends and the reduction of the capital gains tax can go a long way toward helping to mobilize the resources for increased capital formation.

Another requirement for a strong investment climate is that inflation is not allowed to accelerate. In the context of our present situation this is a must, because if a belief that inflation might drift upward were to take hold, decision makers might postpone building new capacity in anticipation of a hard landing. Left unchecked, inflationary pressures would increase and contribute to a self fulfilling prophesy. Hopefully, our policies of the last twelve months have minimized this likelihood and bolstered investor confidence.

It must also be recognized that in order to promote greater capital formation real interest rates have to be reduced. Nominal long-term interest rates have declined on balance since the last recession, accompanied by a downward movement in long-term inflationary expectations. But real interest rates have been kept high by the large public sector borrowing requirements. Thus, a reduction in the federal budget deficit can be an important factor in promoting investment and thereby sustaining the present expansion.

THE BUDGET DEFICIT

This brings me to the budget deficit. It is highly promising that the principles of a bipartisan budget accord for fiscal year 1990 have been agreed upon. The agreement calls for a deficit of $99.4 billion, in conformance with the targets embodied in the Gramm-Rudman-Hollings law.

I hope that this budget agreement will eventually evolve into tangible budget reductions because there is new pragmatism and a willingness to compromise on behalf of all parties. Looking beyond the coming year, it is important that this progress will be sustained in future years as well until fiscal responsibility is again the norm.

It should be borne in mind that one reason for the resiliency of the current expansion has been a rededication to incentives - incentives to innovate, invest, produce, and work. Reducing the distorting effects of taxation has been an important aspect of this emphasis on market incentives. It would therefore be unwise to adopt a deficit reduction plan which substantially rolls back the progress we have made in this area. Hence, it will be essential to progressively close the fiscal gap through reduced spending in the interest of greater economic efficiency and the continued health of the U.S. economy.

It is well known that foreign savings have thus far been an important factor in preventing a serious "crowding out" of our private sector. Foreign investors have flocked to our shores not only in pursuit of higher returns, but also because of the fundamental strength of the U.S. economy, the size of the market, and a relatively unencumbered regulatory environment. However, we can not rely upon this source of funds indefinitely, for at some point in the future foreign portfolios are likely to become saturated with dollar-denominated assets. In addition, the mounting debt service burden of our external liabilities can reduce our future standard of living and that of our children.

The restoration of fiscal balance is, therefore, in our own long-term interest. This will also have a favorable effect on our external deficits; the topic to which I would like to turn next.

EXTERNAL SITUATION

The U.S. trade deficit contracted by $32 billion in 1988 as a result of the combined effects of a more competitive exchange rate and favorable economic growth abroad. However, there was some moderation in the adjustment process in the second half, despite healthy gains in non-agricultural exports. The import side of our trade balance has so far responded only sluggishly to the past fall in the value of the dollar. To some extent this can be attributed to the willingness of foreign producers to accept lower profit margins. But more importantly, it reflects the strong domestic demand for goods and services as our growth continued.

We can be more hopeful for the future on the import front. There are indications that the slowing domestic demand is beginning to curb imports - a tendency which should persist in the near term unless higher oil import prices put that goal out of reach again. It is encouraging that the first quarter GNP data showed a significant increase in net exports compared to the previous quarter - largely due to a deceleration in import growth.

Furthermore, in terms of both price and product quality, American producers are now stronger competitors. They have streamlined, retooled, achieved better cost control, and are keenly aware of international competition in price and quality terms. American firms are thus poised to reclaim lost market share both here and abroad.

The United States is now in rough balance on trade with Europe. Healthy growth in Europe is likely to continue as that region is increasingly being invigorated by the dynamics of full economic and financial integration in 1992. Assuming that this integration will not result in the erection of additional barriers toward non-European countries, our exports should continue to benefit from a more dynamic and liberalized European market.

We are still running a significant trade deficit with Japan and several other Asian countries and more progress is required. In this regard, we are hopeful that the vigorous domestic demand growth in Japan will be maintained, and that it will be coupled with further steps to open domestic markets to foreign products.

In the smaller Asian countries, more realistic exchange rate policies and the removal of protective barriers will be helpful in reducing our imbalance.

I have recently suggested some unorthodox means for further improving our export performance. In my opinion, the unexploited export potential of the United States rests to a considerable degree in our small and medium-sized firms. In this regard, the European movement toward greater uniformity in regulations and standards will make it easier for our small to medium-sized producers to pursue sales in Europe. On our part, a significant step forward can be the swift conversion to the metric system. This will enable U.S. producers to sell abroad without costly modifications and will allow them to capture sales now lost simply because products are calibrated in different units of measurement.

Provision of globally integrated financial services to small and medium-sized firms can also serve to boost our exports. Presently 85 percent of all small American manufacturers finance their own foreign trade. This uses up valuable capital and is an inefficient use of these scarce resources. Our present banking system is highly fragmented and compartmentalized. Restrictions on interstate banking limit the support that American banks can provide to small and medium-sized firms all over the nation. The liberalization of our interstate barriers to banking could significantly help these firms to penetrate new markets abroad. I find it amazing that the nations of Europe can agree so quickly on an integrated banking system for the entire continent, while we continue to debate the pros and cons of allowing American banks to do business in other states.

INFLATION - ADVERSELY IMPACTED BY TEMPORARY FACTORS

Let me now turn to inflation and monetary policy. Until recently we have enjoyed a remarkable stability on the inflation front. With the exception of the abnormally low CPI increase in 1986, annual CPI increases during the last five years have ranged from 3.5 percent to 4.4 percent. Similar stability has prevailed in compensation per hour and manufacturing unit labor costs. However, in recent months the news on inflation has been more disturbing, particularly at the producers' level. The numbers have been especially disconcerting because the economy is already operating at a high level of resource utilization.

However, it is reasonable to expect that the recent pickup in external price pressures will soon dissipate.

Food prices should stabilize as agricultural output returns to normal levels. In spite of oil spills and blow-outs, recent history of the global oil market suggests that prices beyond $20 per barrel will probably not hold for long. On the supply side, with the variable cost of producing the marginal barrel below $10 per barrel, the incentives for additional production are considerable. On the demand side, higher prices will also dampen demand and encourage substitution. Moreover, the oil price increase will most likely have a one-time effect on the inflation rate and is unlikely to lead to a spiralling price level.

MONETARY POLICY

Put simply, I just do not believe that the preconditions for a sustained acceleration in inflation are now in place. Since I came to the Federal Reserve in August 1986, M1 growth has averaged 5.2 percent, M2 growth 4.5 percent, and M3 growth 5.8 percent. Each year, the target ranges for monetary growth were lowered to indicate the Federal Reserve's long-term commitment to monetary stability.

For the last 12 months, growth in M1 was 3 percent, M2 growth 3.7 percent, and M3 growth 5.3 percent. Thus, I fail to see where a sustained inflationary surge might come from.

With the economy now at high resource utilization levels, the Federal Reserve has been especially mindful of inflationary tendencies. We have thus been moving preemptively to restrict reserve availability, while at the same time exercising due caution so as not to push the economy into a recession: while monetary growth is restrained, it is still positive.

And while short-term interest rates have increased by more than 300 basis points, long-term rates have shown a remarkable stability. This is gratifying not only because it shows no increase in inflationary expectations, but also because long-term interest rates are pivotal for investment decisions and thereby future growth.

As you know, it takes time for monetary policy to relieve pressure on prices. The restraint we have already put in place, coupled with the emerging deceleration in the economic expansion, should eventually have a favorable effect on inflation. What is needed now is a bit of patience to allow the policy that is in place to work.

Over the longer term, our resolve to contain inflation and to make progress toward price stability will guide the course of monetary policy and we will remain vigilant for any signs of increased inflationary pressure.

The goal of price stability is an appropriate guide for monetary policy, for in the long-run, it is also the path to sustainable and stable economic growth. In a market economy, price stability permits the clear reading of the price signals essential for an efficient allocation of resources. In addition, by reducing uncertainty, it promotes productive investment and stability in financial and foreign exchange markets, thereby laying the foundation for future economic growth.

CONCLUSION

To conclude, leaving the statistical adjustments for last year's drought aside, the general outlook is for moderate economic growth and subdued inflationary tendencies. At present, the imbalances which traditionally precede a recession are not visible and indications are that the current expansion will continue. Capacity expansion and continued growth in exports should help to maintain the growth momentum.

Economic policies which will foster investment and support export growth are essential to sustaining that growth. In this regard, governmental and consumer spending restraint can help substantially by relieving the pressure for high interest rates in credit markets. Monetary policy can then continue to concentrate on providing a framework of price stability in support of economic growth.

I agree with those observers who argue that we have to walk on a tight path and that the margin for error is unusually small. But I also believe that we can succeed in providing the framework for a continued non-inflationary expansion.

Let me assure you that the Federal Reserve is not out to take the proverbial punchbowl away -- we just would like everyone to drink a bit more slowly, so that the party can last a longer time.

Thank you very much.