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THE OUTLOOK FOR THE U.S. ECONOMY

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By

H. Robert Heller

I am happy that you asked me to speak today on the outlook for the American economy because there is much to be proud of. But at the same time, we have to face important challenges: we have to prevent a resurgence of inflation, put our financial house in order, and begin to restructure the American economy.

Economic growth has been sustained much better than one could have hoped for when the current expansion began five and a half years ago. In 1987, economic activity expanded at a robust pace. Fourth quarter GNP has just been revised up to 4.8 percent. At the same time, the unemployment rate dropped to its lowest level since 1979, and consumer prices last month showed only a 0.2 percent increase.

We have every reason to believe that economic activity will continue at a healthy pace - in spite of the doomsday prophets who always see a recession just a few quarters ahead.

The fact that we are moving forward is plain in the surge of U.S. industrial activity. Operating rates are climbing, investment is booming, and new jobs are being created at a rapid pace.

That progress is even more impressive because it takes place against a background of large imbalances in our economy: excess federal spending compared to tax revenues; excessive imports compared to our exports; and insufficient domestic saving compared to our need to finance our investment. These imbalances must be rectified if they are not to imperil growth in the years to come.

In this regard, a continued reduction in the federal deficit is crucial. Lowering the federal government's claims on domestic savings and reducing its presence in the credit markets will make more financial resources available to American industry for investment in capacity and competitiveness.

Attaining a better balance between domestic saving and investment will help us achieve an improved external equilibrium. It will also allow us to reduce our dependence on foreign funds.

The fall in the value of the dollar should help American business to price more competitively in world markets and to expand its market share at home and abroad.

For the year as a whole, we expect economic growth in the 2 to 2-1/2 percent range, which is in line with the Administration forecast.

We also expect only moderate inflation, of about 3-1/2 percent for the year, though the Administration's forecast is slightly higher than that.

Old Sources of Growth Weaken

The old workhorses of consumer spending, defense spending, and construction, which led the expansion from 1983 until 1986, are now tired. In those years, rapid growth in consumption was the force driving domestic spending. But this burst in consumer spending exceeded not only the long-run trend growth in real disposable personal income but also actual income gains during that period. In other words, our consumption grew faster than our income. That situation cannot be sustained forever.

Last year, consumer spending slowed markedly, and the stock market crash darkened its prospects. At this juncture, a deep retrenchment in household spending does not appear to be in the cards; but the consumer is certainly more cautious about fancy sports cars, vacations in Europe and other discretionary spending.

Looking ahead, continued moderate growth in consumer spending appears likely - and, indeed, desirable. Slower growth in consumption will foster a better balance between consumption and income, allow our savings to increase, and therewith provide the wherewithal for badly needed investment.

Investment Surges

After a sluggish 1986, business spending for plant and equipment revived last year. Factories reopened and upgraded their facilities as the drop in the value of the dollar on international currency markets made American firms more competitive at home and abroad.

The demand for new business equipment continues to surge, and orders for capital goods post solid gains. All that bodes well for the future because we are building additional capacity and enhancing our productivity. Both of these developments are important to sustain domestic growth and to keep our export boom alive.

In some industries, booming export sales have combined with rising domestic demand to push capacity utilization rates to high levels. The pickup in industrial activity has also encouraged additional spending on industrial buildings. Yet, we still face serious overbuilding of offices in many cities.

Until recently, the news about residential investment has been disappointing. Home sales and starts slumped at the turn of the year. But mortgage interest rates have fallen a point and a half from the October peaks, and the effects of these lower rates have finally begun to show through in stronger housing starts. Although the market for multi-family housing units remains lackluster, the lower mortgage rates have made new homes more affordable and should promote sales and construction of single-family homes.

More Fiscal Discipline Needed

One of the most encouraging developments of the past year has been the substantial progress made by the Congress and the Administration in reducing the federal deficit. By clamping down on spending, and with the help of favorable boosts to revenues, the budget deficit was cut $50 billion in fiscal 1987.

We must recognize, however, that the recent progress has merely dented the problem. Federal spending, which took 20 percent of GNP during the 1970s, claimed 24 percent between 1983 and 1986. In contrast, tax receipts remained stable at 19 percent of GNP during the last two decades. Now, the gap between spending and income amounts to 3 percent of GNP, or $150 billion.

The implications of these trends in outlays and revenues for the years to come are clear: we must further reduce the ratio of government spending to GNP. The Gramm-Rudman-Hollings legislation laid down an ambitious deficit-reduction program, and it remains the standard for all other deficit-reduction packages. I hope that the new National Economic Commission also will help in the difficult task of determining further politically feasible cuts in spending.

Dependence on Foreign Capital Must Be Reduced

To a significant extent, heavy inflows of capital from abroad have cushioned domestic capital markets and investment against the impact of the federal deficit. Indeed, these foreign capital inflows are now, roughly, equivalent to the credit needs of the federal government.

However, history shows that a country cannot forever depend on savings from abroad. At some point, we will have to generate our own financing for our spending needs. Waiting can only compound the problem because sooner or later the costs of external debt service will begin to drag heavily on our economy.

Thus, without further reductions in the federal government's claims on savings, we run the risk of putting severe pressure on foreign exchange and financial markets sometime in the future.

Exports Pose Challenge

The external sector will be the key to U.S. economic growth in the years to come. Now that the dollar is at a more reasonable level, our international competitive position has dramatically improved so that American business can again conquer new foreign markets. Exports are now surging over 15 percent per year in volume terms.

American firms have in general maintained good price discipline. Thereby they have helped to consolidate the competitive advantage gained by the fall in the U.S. dollar. This new, outward-looking orientation has not been easy for many firms: they had to learn new languages, absorb new legal codes, apply new technology, and develop new marketing and distribution systems. But this expansion of export business will be essential if our country is to remain a leader in the world economy. And the payoff to American businessmen and workers will be substantial.

But these efforts should not be confined to foreign sales. American business should be able to increase rapidly its penetration of domestic markets -- all the more easily because marketing and distribution systems are already well established. Indeed, the higher prices for imported goods have already begun to restrain the growth of import volume. Much of last year's increase in imports was attributable to the surge in demand for business machines and the buildup of petroleum stocks. The flow of consumer durables and apparel into the country actually declined, particularly in the second half of the year.

The benefits of these trade shifts are now obvious in our manufacturing sector. Industrial production, which had been lackluster in 1985 and 1986, grew almost 6 percent last year. Much of that pickup was attributable to a sharp increase in production at industries with above-average trade shares. Industrial materials, high-tech equipment, and even traditional capital goods all did extremely well. The weaker dollar and export subsidies also strengthened agricultural exports, and thus further helped to reduce the trade deficit and to ease the farm problem.

Because calls for protectionism still can be heard from those less optimistic about the trade deficit, I want to applaud the efforts to foster American and Canadian well-being through the Canadian/American Free Trade Agreement. As you know, on January 2, President Reagan and Prime Minister Mulroney initialed this important document. If the agreement is approved by Congress and Parliament, it will open the way for broader trade flows between our two countries. Lower consumer prices and higher employment in both countries should result.

Inflation Remains Under Control

What do these prospects for continued growth and the movement toward better economic balance imply for inflation?

First, the process of external adjustment has involved a pronounced acceleration in the prices of imported goods. Over the past two years, this trend has been particularly noticeable in the prices of imported consumer goods, such as motor vehicles, photographic equipment, and apparel. Nonetheless, the effect on domestic inflation has been smaller than most forecasters predicted. One key reason is that foreign producers have sacrificed profits to maintain their market shares. But we cannot count on them to do that indefinitely; and we should expect more upward adjustments in prices of imported goods this year even though the dollar is now much more stable. What is crucial is that the impetus to inflation from this change in relative prices stop with the direct effect on the prices of imported goods and does not feed through to domestic prices and ultimately wages.

For many years, we have enjoyed labor cost developments that have enhanced our international competitiveness. These developments have helped to moderate increases in producer prices despite much higher costs for materials. In the non-farm business sector, increases in unit labor costs have averaged less than 2 percent in the past two years; in manufacturing, unit labor costs have been flat. American labor has reaped the rewards in the form of an unemployment rate of only 5.6 percent and the creation of over 15 million new jobs in the current expansion. Over two million of these jobs were created in the last six months alone - evidence of the continued strength of the expansion.

Continued advances in productivity have improved the performance of the manufacturing sector. The pressure to lower break-even points and to be more competitive in world markets has spurred businesses on to noticeable gains in efficiency.

As a consequence, producer prices have increased less than one percent per year since 1983. Producer prices have been unchanged for the last half year. If we are able to perpetuate these trends, the outlook for further price stability is bright indeed.

Monetary Policy Carefully Balanced

We at the Federal Reserve are committed to do our share to sustain this favorable trend.

As you know, growth in the money supply was moderate for most of 1987 as we leaned in the direction of countering potential inflationary pressure from the depreciation of the dollar and the rise in oil prices. The stock market crash in October -- whatever the ills it brought -- also contributed to a lowering of inflation expectations.

Subsequent to the crash, the maintenance of financial stability and confidence became crucial, and the Federal Reserve increased liquidity rapidly. This easing should be seen as a precaution against serious retrenchment by businesses and consumers, and it seems to have been successful: confidence rebounded, and the fallout from the stock market decline has remained within narrow bounds.

For 1988, our aim is to continue to support economic growth at a pace consistent with further progress toward price stability. In February, the Federal Open Market Committee set the 1988 target ranges for growth of M2 and M3 at 4 to 8 percent. The midpoint of this range, 6 percent, is a full percentage point lower than last year's target, and is designed to keep inflationary pressures in check.

We must also be sensitive to the loosening of the linkage between monetary growth and income in recent years. It therefore behooves us to factor a broad range of economic and financial indicators into our decision-making. Interest rates, exchange rates, and commodity prices determined in auction markets not only are sensitive indicators of inflationary expectations; they also are available instantaneously, and they offer timely information on the economic and financial environment that should not be neglected. With careful surveillance of the economic and financial environment, we can and will detect early indicators of a resurgence of inflationary or deflationary pressures and take timely action to forestall greater economic and financial problems later on.

The Challenge Ahead

As I indicated at the outset, we have begun to make considerable progress in restoring better balance to the U.S. economy. Yet the task ahead remains challenging indeed, and we have no assurance that everything from here on will go according to plan. The reduction and eventual elimination of the federal deficit continues to be of central importance. We must also increase our domestic saving if we are to generate the financial resources we need for our investment program -- a program that, in turn, will lay the foundation for continued noninflationary growth.

But if we persevere, there is good reason to expect continued progress. For American business and workers, that perseverance calls for self-discipline and determination. An equal effort will be required by the political leadership in the Administration and in Congress. And we, at the Federal Reserve, must remain disciplined in our conduct of monetary policy.

We confront formidable challenges, but they are, in the end, tractable. We know our goal -- to maintain growth within a framework of financial stability.

The remaining challenge lies in mustering the discipline to execute our plans. I am confident that we will succeed.