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THE OUTLOOK FOR THE U.S. ECONOMY

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THE OUTLOOK FOR THE U.S. ECONOMY

We are now in the fifth year of the current expansion and the economy continues to grow with surprising vigor.

New records continue to be established on an almost weekly basis. The employment rate is now near an alltime high, while the unemployment rate has reached a six year low.

The stock market continues to surge ahead and interest rates are close to their lowest levels in ten years.

But during this expansion, large imbalances have developed in the government and in the foreign trade sectors. The challenge confronting us during the next few years will be to rectify these imbalances.

A second challenge is to consolidate the enormous strides that we have made in the fight against inflation and avoid backsliding into an inflationary environment. As you well know, we entered this decade with double-digit inflation rates and stagflation became a new household word. During

the last year the consumer price index rose only a modest 1.1 percent. While we at the Federal Reserve have a special responsibility to fight inflation, the containment of inflationary tendencies in our country will be up to all of us.

The Consumer Is Still Strong

The American consumer has been the mainspring of the current expansion. New jobs continue to be created at a rapid pace and helped by this continuing surge in employment, salary disbursement continues to climb at a rapid pace. American farmers still benefit from large federal subsidy payments.

The federal tax cuts contributed to a significant decline in personal tax payments early this year. On balance, these tax cuts provide a \$15 billion benefit to American consumers per year. Considering that many Americans made substantial gains in stock and bond markets that resulted in a record level of net personal wealth, it comes as no surprise that consumer expenditures continue to increase. At the present time, the data on consumer spending are strongly dominated by wide swings in automobile purchases that were influenced by sales promotion programs of the big automakers and the phase-out of the

tax deductibility of sales taxes. Looking to the future, there is every reason to expect that American consumers will continue to provide a modest but positive stimulus to the economy. But it also stands to reason that consumers will no longer rely as heavily on debt finance as in the past.

Investment Remains Sluggish

The current pace of business fixed investment is very sluggish. Here, too, we observed a bunching of expenditures in the last few months of 1986 when business firms could still take advantage of favorable tax treatment. Now we experience a lull that reflects these advance purchases.

Of course, the overall data on investment will be influenced by the continued decline of the non-residential real estate sector which continues to suffer from overbuilding - especially in the large cities. At the present time, construction activity is running at only 75 percent of its 1985 peak.

However, there is reason to believe that an improved trade performance may well have a positive effect on investment spending in the coming year, and consequently I would expect that business investment

spending will perform well during the next few years.

The residential housing sector continues to benefit from a high demand spurred by low interest rates. New home prices have risen considerably over the past year, but after adjustment for quality changes we observe only a 3 percent increase in prices. However, there are large regional differences. In the northeast new home prices have jumped 20 percent over the past year after adjustment for quality changes. On the other hand, housing prices in the oil states are depressed.

The Need For Fiscal Discipline

Turning to the government, it is clear that the persistent growth in the share of GNP absorbed by federal spending is largely responsible for the very large budget deficits of the past few years. During the last fiscal year, federal spending amounted to 23.8 percent of GNP while receipts were only equal to 18.5 percent. This left a deficit of 5.3 percent of GNP to be financed.

It is particularly disturbing that the deficit is still so large in this advanced phase of the economic expansion. That deficit is due to excessive spending

and not due to tax cuts. Tax revenues stayed virtually constant as a percentage of GNP since the late 1970s, while federal spending continued to soar. It therefore makes sense to reduce the federal deficit through spending restraint rather than the imposition of new taxes. The imposition of new taxes would tend to rekindle inflation and certainly not make us more competitive in international markets.

In spite of some recent backsliding, progress is being made. Last year, we had a federal deficit of \$221 billion that needed to be financed. This year, the deficit will be \$50 billion smaller. This amounts to a reduction by one full percentage point in terms of GNP.

As long as we succeed in holding real federal expenditures constant and benefit from tax revenue increases due to economic growth, the budget deficit should continue to shrink. But clearly it is important to avoid a new burst of mandated expenditures. In a macro-economic sense, the declining federal deficit represents a contractionary influence. It sets resources free that can be utilized in other sectors of the economy.

International Trade Will Expand

This brings me to the international trade sector, which is now poised to expand. In terms of its contribution to economic growth, I believe that this will be the leading sector in the next two years. But we have a lot of catching-up to do.

Clearly it will be easier for American industry to make progress on the import-competing front than to penetrate and capture new foreign markets. Here at home we have well established distribution systems and the rise in the value of the yen and the European currencies will allow American manufacturers to compete more effectively against their foreign competitors.

To capture and penetrate new foreign markets will be more difficult. In the agricultural sector we continue to face stringent protectionist policies in Japan as well as in Europe. In the manufacturing sector it will be exceedingly difficult to compete against entrenched domestic suppliers. Foreign government procurement policies are particularly difficult to change as price incentives seem to play only a secondary role in this sector.

This leaves the possibility for us to compete more effectively in the third-country markets of the world. But it will be difficult to make quick gains because most of these markets are growing sluggishly.

Latin American economic growth is constrained by the debt burden that these countries carry. There is not much hope for a rapid improvement in the African economic situation. The Middle East is dominated by civil strife and outright wars. In Asia, we continue to have sluggish growth in the commodity-exporting countries. Clearly, it will be difficult for Americans to compete head-on in the newly industrialized countries of Korea, Taiwan, Singapore and Hong Kong. That leaves Europe and Canada as potential export markets. I believe that the free trade agreement with Canada, which is now being negotiated, would be exceedingly helpful in allowing American producers to compete more effectively in that country.

We should also keep in mind that in trying to capture foreign markets American producers face enormous obstacles. New languages have to be learned and new legal systems adapted to. Different health and safety codes have to be observed and technological adaptations will in many cases be necessary. All that will take time and effort to accomplish.

To sum up, the outlook for economic growth is not at all unsatisfactory and the U. S. economy should be able to expand by almost 3 percent during the coming year.

Inflation Outlook

What does all that imply for inflation?

During the last year, the inflation performance of the U. S. economy has been excellent. The consumer price index advanced only 1.1 percent during the course of 1986. But the main reason for that superb performance was the drop of almost 20 percent in energy prices. Prices in all other sectors continued to increase at a annual rate of almost 4 percent. In particular, service sector inflation continued at over 5 percent.

There is little reason to assume that energy prices will drop in 1987 - as a matter of fact there is reason to expect a slight increase. Since the December OPEC meeting domestic energy prices have turned up.

Prices of crude petroleum climbed about 20 percent in January and another 4 percent in February. At the retail level energy prices have also begun to increase and it is likely that there will be a further pass-through of higher crude oil prices as the year unfolds.

In other words, we will be back to the regular inflation performance that we have come to expect during the last few years. Overall, the consumer price index may well rise by about 4 percent in the current year, which represents a return to the long-run trend of the last six years.

However, the more broadly based GNP deflator is likely to increase only 3 percent. This discrepancy is largely due to the fall in the value of the dollar which impacts more strongly on the consumer price index because it directly reflects the prices of expensive imported goods. Instead, the GNP deflator more closely reflects the prices of goods actually produced in the United States.

One reason why I am pretty optimistic on the inflation

outlook is that the performance of wages and salaries continues to be very satisfactory. Hourly earnings are rising now at a modest pace of only 2 percent and total wage costs are increasing at slightly less than 3 percent per annum. This has a very favorable impact on the competitiveness of American industry. We gain an added competitive advantage because wage costs in most other industrialized countries are increasing at a more rapid pace.

Monetary Policy

What does that imply for monetary policy?

As you well know, the monetary aggregates grew rather rapidly during the past year. Measured from fourth quarter to fourth quarter, M1 grew by over 15 percent last year while M2 and M3 increased almost 9 percent.

This high monetary growth reflected a variety of circumstances. For one, inflation plummeted sharply as I pointed out previously. As people regained their confidence in the currency, they began to hold more of it. This is a natural catch-up in the demand for monetary assets that one can observe at the end of any inflationary episode.

Second, we went through a period of financial deregulation that made it possible for banks and thrift institutions to pay interest on transaction balances. Consequently, it became more attractive to hold money in interest bearing NOW accounts and other transaction accounts.

Third, the rapid increase in the value of stocks and bonds resulted in a sharp increase in wealth. It stands to reason that people want to hold some of this wealth in the form of money.

As a result of all these cross currents affecting the demand for money, the monetary aggregates behaved in an extraordinarily volatile fashion last year. As a matter of fact, the behavior of M1 became so unreliable that we at the Federal Reserve decided not to establish a formal M1 target for the current year.

While it is difficult to provide hard evidence, it stands to reason that the effect of lower inflation and financial deregulation on the monetary aggregates has now largely run its course. Consequently, monetary growth may return to more modest levels. In my view, this would not only be a logical, but also a most desirable development.

As a matter of fact, the monetary aggregates have grown only very modestly since mid January, when the bulge related to year-end financial activity disappeared. I would not be surprised at all if the monetary aggregates were to grow rather slowly during the balance of the year as well.

The Need For Discipline

As I stated at the beginning, we are now in a period where we, as a nation, are trying to execute one of the most difficult policy maneuvers ever attempted: namely, to wind down our \$200 billion federal budget deficit and at the same time improve our trade performance by almost the same amount.

The magnitude of that task is truly astounding. It will affect the economic life of every American worker and consumer. As can be expected in an undertaking of such enormous dimension, there is no assurance that everything will go smoothly and according to plan.

One area that bears watching is inflation. Prices of imported goods are rising at a rate of about 7 percent. The pricing behavior of American producers in response to price increases of their foreign competitors will be crucial for our economic future.

If American producers are going to match the price increases of their foreign competitors, they will not only generalize the inflationary forces emanating from the foreign trade sector but will also be unable to gain domestic and foreign market shares. Thus our own trade performance will improve slowly or perhaps not at all while inflation at home will increase. A return to the stagflation of the late 1970s may well be the result of such a behavior pattern.

If, on the other hand, American producers take the opportunity offered to them and hold their prices stable, they will gain rapidly in competitive advantage. Consequently, they should be able to expand their market share here at home and to develop new foreign markets.

Let me take just one more moment of your time to deflate a popular myth that is cited frequently these days. It is the myth that inflation and interest rates inevitably have to rise as a consequence of the decline in the dollar exchange rate. This is simply not so.

During the early 1980s the German mark and the Japanese yen declined sharply in value -- as a

matter of fact, it is precisely that currency movement, which is being reversed at the present time. During that period of decline in the mark and the yen, inflation rates and interest rates declined in both Germany and Japan. In Germany, consumer price inflation declined from 6.3 percent in 1981 to 2.2 percent in 1985, while money market interest rates dropped from 11 percent to 5.5 percent. Similarly, in Japan inflation dropped from 8 percent in 1980 to a mere 2 percent in 1985, and interest rates fell from 11 percent to 6 percent.

While a period of currency depreciation is no time for complacency, there is nothing inevitable about a decline in the external value of the currency and an associated surge in inflation and interest rates.

If we are disciplined and determined, we can continue to contain inflation, while enjoying the benefits of low interest rates.

The crucial decisions are now up to us. To fail when we have the opportunity to move ahead would certainly be most frustrating.

To succeed on the international front, American businessmen will need to exercise a high degree of

self-discipline and show a lot of determination.

That same degree of self-discipline will be required in the government sector if we are to bring the federal deficit under better control.

And we at the Federal Reserve will have to be disciplined in our conduct of monetary policy.

These are the keys to our future success and prosperity. I trust that we will not let that opportunity slip away.