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The Outlook for the U.S. Economy: Risks and Opportunities

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In no other society is the outlook for the economy discussed, reviled, analyzed, synthesized, and made the subject of meetings like this as much as it is in the United States. Perhaps it is because of our role in the global economy: the world recovery and economic expansion has been particularly geared around that of the United States in the past two plus years. Perhaps it is because we are a nation of statisticians--we measure and forecast our economic activities to a higher degree than any other nation. I believe we have dissected recent economic activities in part out of our frustration with the performance of our forecasters in various organizations, including those with the best reputations and the most elaborate econometric models. In part, our analysis has been spurred by observed changes in our economic relationships. The accelerated openness of our economy to foreign providers of both goods and services is one trend--the unprecedentedly large flow of foreign capital which is accompanied by the equally unprecedented trade deficit is another. My task today is to review with you my comments regarding the economic outlook and to review certain risks and some opportunities which appear to characterize this stage of the economic expansion.

In broad terms, the U.S. economy appears to be approaching a so-called "soft landing" in 1985. Real GNP appears to have decelerated into a more sustainable growth rate between 3-1/2 or 4-1/2 percent, with the inflation rate declining gradually. A year ago this configuration would have been called a rosy scenario, but it is today broadly consistent with the consensus view of the forecasting community. Indeed this very consensus gives one pause in view of recent forecasting errors. Moreover, there seems to be less disagreement among forecasters than usual. It is true that there are those who expect a recession this year and others who think inflation will re-accelerate, but the contrarians are in a distinct minority. Most forecasters foresee real

GNP growth in the 2-1/2 to 4 percent range, unemployment dropping slightly to around 7 percent and inflation either increasing moderately above its 3-1/2 percent rate last year, or falling moderately below last year's rate.

Where are the risks in this consensus view? I do not think that the major contemporary risk lies with inflation. The chance of inflation re-accelerating this year, or in the next few years, seems smaller than has been characteristic of recent expansions. First, the weight of scholarly evidence still indicates that over the long haul inflation is a monetary phenomenon, and the Federal Reserve has no intention of permitting the monetary aggregates to grow so rapidly for a sustained period of time--long enough to initiate a new round of secular inflation.

Second, inflationary forces and factors currently have some downward momentum, on balance. Developments in wages and productivity are among the most important factors in this regard. Data recently released by the Labor Department suggest that for 1984 as a whole, compensation per hour rose by 4.6 percent, and productivity increased by 3.1 percent. These figures imply an increase in unit labor costs of only 1.5 percent. These costs increased by only 1.4 percent in 1983 compared with a very high 9.1 percent average increase in the preceding 5 years.

Moreover, there are few leading indicators giving reason to believe that this situation will reverse itself in the near future. Wages in major union contracts agreed to last year were down even from their relatively low levels in 1983. Many analysts now think that productivity is on a new higher trend line after its sluggish performance in the middle and late 1970s. It does not yet appear possible to conclude that the new trend growth rate is 1-1/2 percent or 2-1/2 percent, but it does appear to be higher than its previous 3/4 percent trend. Greater productivity paves the way to further disinflation in the years to come.

On balance, the degree of slack in the markets for the factors of production, measured by the unemployment and global (not just U.S.) capacity utilization rates, also suggests less danger of inflation. There is considerable debate about the current "full-employment" unemployment rate. However, I am not aware of a serious commentator who argues that it is as high as the 7.4 percent civilian unemployment registered in January.

Further, I argue for an interpretation of the capacity utilization rate that is somewhat more complicated. For total U.S. industry, the 81.9 percent utilization rate in December 1984 still is somewhat below its 82.4 percent average or "full" utilization value of the previous 15 years. We added 3 percent or more to the base via substantial investment last year. Only for manufacturing is the December utilization rate slightly higher than its long-run average value. Agriculture, mining, housing, and commercial construction are, or soon will be, underemployed. Furthermore, today the world economy is more highly integrated than ever before, and one also must consider productive capacity available abroad. The rather scanty and impressionistic evidence available suggests that there currently may be some unused capacity available in other developed countries taken as a whole: available in the sense of being capable of utilization to supply U.S. markets.

Commodity prices and exchange rates are two factors that in the past have caused inflation to deviate temporarily from long-run underlying rates. Both of these factors have applied downward pressure to inflation in recent years. Admittedly, it is difficult to extrapolate from past patterns because these market factors swing quickly and sharply. In any event, commodity prices have declined sharply in the past year, with prices of industrial materials having fallen by more than 10 percent in 1984. The risks now appear to be mainly on the downside in the important area of oil prices, since OPEC is having great difficulty holding itself together in the face of conservation efforts and a large existing inventory of oil on the world market.

On a more worrisome note, many analysts have predicted for the past several years a decline in the value of the dollar and the associated upward pressure on U.S. inflation rates. This, of course, would reverse the pattern of the past four years in which the trade-weighted value of the dollar rose sharply. The perception that the dollar may begin falling appears largely to be based upon the argument that the U.S. cannot indefinitely sustain a large current account deficit. Foreigners, it is argued, eventually will become saturated with the U.S. financial assets that must be sold to nonresidents to finance that deficit. This is a sensible argument, but unfortunately little seems to be said about the all important question of timing. Will this happen this year, in 2 years, or in 5 years? Moreover, with respect to inflation in the U.S., it apparently would take a precipitous decline in the dollar to create large, albeit temporary, problems. One rule of thumb is that a 10 percent dollar depreciation implies 1-1/2 percent higher consumer prices by the end of 2 to 3 years. Thus, although the dollar must be considered a threat to the moderate U.S. inflation rate this year and next, it would take a dramatic set of events to create major consumer price problems.

Finally, inflation expectations are an extremely important element in the inflation outlook. To a large extent, this factor probably already has been captured in some of the developments discussed. Certainly the moderation in wages, in recent years, and in wage contracts signed recently, must reflect reductions in inflation expectations. Surveys are the most available measures of expectations. These surveys generally show gradual declines in expected inflation since a peak in 1980. The December 1984 Decision Makers Poll by Richard Hoey and Helen Hotchkiss, for example, shows 10-year inflation expectations dropping to 5.61 percent compared with a peak of almost 9 percent in late 1980. My qualitative impression from reading the financial press is that expectations of inflation may have come down another notch more recently, as awareness has awakened that inflation in 1984 as a whole was quite moderate.

It also appears that the Federal Reserve has built up a good deal of credibility in recent years for its anti-inflation stance. It seems that temporary increases in the rate of growth of the monetary aggregates, for example, do not cause the concern in the marketplace that they once did, whether measured by sudden changes in prices of financial assets or market commentary. This may give us more flexibility and increases the chances of success in dealing with cyclical problems in the economy, when they occur.

Turning to the outlook for the real economy, in my opinion the most likely outcome is that real GNP will show a healthy but moderate increase in 1985, hopefully enough to produce small decreases in the unemployment rate later in the year. But, I will elaborate, there is a reasonable chance of a growth recession this year with positive GNP growth accompanied by a rising unemployment rate.

The probability of such a growth recession was diminished by the announcement of 3.9 percent real GNP growth in the fourth quarter of last year, following a sluggish 1.6 percent growth in the third quarter. This pickup in GNP, in combination with sizeable declines in long-term interest rates (for example, the 10-year Treasury rate has fallen by over 200 basis points since June), suggests room for cautious optimism. Another positive sign, and one that often suggests strength in the future, is the greater growth of the monetary aggregates, especially M1, after the period of decline in July through October. In the latter period, M1 declined at about a 1 percent annual rate. However, with declines in short-term interest rates since August, including two discount rate reductions, M1 rose at nearly a 10 percent rate in November and December, and continued to rise over the first several weeks of January.

Unfortunately, the short-run outlook for real GNP is not totally unclouded. On the negative side are movements in a number of real economic factors considered to be leading indicators of economic activity. These factors can be summarized by the composite index of leading indicators, which fell in two of the last three months, and in four of the last seven months, now standing below its level in May of last year. Manufacturers' orders of non-defense capital goods, a leading indicator of business spending, fell on balance in the third and fourth quarters of last year. These factors should not be overemphasized, since leading indicators sometimes have given false signals before. However, they are a source of concern.

Historically, any time GNP was expected to make a soft landing, there was a reasonable chance of slipping into a growth recession. This is true almost by definition. A soft landing means that GNP gradually approaches a sustainable growth rate that is consistent with maintaining a full-employment level of unemployment in the long-run. There always is going to be some "normal" margin for error on both sides of the sustainable GNP growth path. By definition, the downside of this range of error involves a GNP growth rate so low as to produce increases in the unemployment rate--that is, a growth recession.

I have noted that some unusual characteristics of the current economic situation are providing the opportunity for sustaining growth without bringing back the specter of inflation which haunted us in the 1970s. Sustaining growth will require continued flexibility in the implementation of monetary policy in order to deal effectively with the downside risks for real GNP noted above. It is of course important that the Federal Reserve maintain its credibility in the marketplace. Changes in policies which would be misinterpreted by the participants in the market as representing anything like "easy money," any two-dimensional interpretation of policy which would have as its objectives only the dimensions of growth and low interest rates, omitting disinflation, would invite an overwhelming probability of failure. Market expectations are not everything, but they are real, and policies which lead participants to take market positions based on their perceptions that monetary policy implementation will be careless of inflationary consequences can produce the self-fulfilling prophecy of rising prices as sellers, consumers, and labor fall back into the practices of the past, practices of anticipating inflation.

Our opportunity today is first to take responsible action in the fiscal policy area by curbing the growth in spending, eliminating programs whose benefits no longer outweigh their costs, and resolving conflicting interests in tax simplification. Such action would free monetary policy to give more attention to sustaining economic growth while maintaining a careful watch for indications of a return of inflation in the future. For monetary policy, there could be an opportunity to maintain the credibility of the Federal Reserve while exercising the flexibility to deal effectively with the downside risks for real GNP. If the concatenation of fiscal and monetary policies could give strong enough indications that the inflation rate will not represent a major constraint, there could be opportunities for the Federal Reserve to move to a more accommodative posture from time to time and thus help to avoid slipping into a growth recession. Economic growth within the limits of the possible is not a panacea, but it is the necessary condition against which responsible policy measures can produce desired economic results. We have the opportunity today to sustain the business expansion without laying the foundation for a revival of inflation in this cycle. Attainment of this objective would limit unemployment and could provide the basis for further inroads on inflation in the years to come. Certainly the attainment of objectives such as these appears to be eminently worth the social costs of adjusting and altering the myriad of ways three levels of government deal with, even serve, the citizenry.