For Release on Delivery
10:30 a.m., E.S.T
Tuesday, December 3, 1985

The Economic Outlook: Risks in A Fourth Year of Expansion

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Agricultural Outlook Conference

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We are fast approaching the end of the third year of economic expansion. The sluggish pace of economic growth over the past five quarters has led some to question whether the expansion will continue in 1986. In contrast, the slightly accelerated pace of expansion in the third quarter has caused observers who focus on growth of the narrow monetary aggregate, M1, to predict a major rebound in both economic growth and inflation next year. The middle ground for the majority of forecasters calls for continued moderate economic growth with no substantial increase in inflation.

Yet the recent record of such prognostications has been dismal for the dismal scientists. The old tried and true relationships built into econometric models are difficult to apply in today's changed and changing economic world. Especially in a period of change, models are much better at providing point estimates than at indicating the type of risks that must be taken into account. The major risks I foresee for next year are on the down side, in part because of continuing signs of economic weakness.

Recent Economic and Inflation Performance

The U.S. economy has been tottering on the brink of a growth recession for over a year. As you know, real GNP has advanced at a pace of less than 2½ percent over the last five quarters, and this growth has been very uneven. Most of the growth has been in the service sector. As a result, employment in goods-producing sectors has been virtually stagnant, causing the overall unemployment rate to be stuck at around 7¼ percent.

Our economy has remained sluggish in the face of a substantial decline in interest rates. Both short-term and long-term interest rates have declined in the range of 3 to 4 percentage points since the middle of last year. Actual and expected inflation has declined much less, so real interest rates have dropped substantially. Nevertheless, sectors that traditionally have responded to interest rate declines of this magnitude have not shown much resurgence this year.

Housing starts, for example, until recently were trending downward despite lower mortgage interest rates. Anticipation of even lower mortgage rates and caution by builders in controlling their inventories may have been at work holding down housing sales. Moreover, more stringent lending standards have been imposed by mortgage lenders and mortgage insurers. The caution apparent in mortgage markets reflects increased concern about higher delinquencies, rapid growth in consumer debt, and other evidence that consumers may be stretching their financial resources. Lenders have oversold easy credit, as you can tell by checking your mail in the morning.

A second factor holding down economic growth has been the growing international trade deficit. Some interest-sensitive spending has grown at a healthy pace in recent quarters. But because of the overvalued dollar, much of the demand for consumer durables and for business capital goods has been met by imports. Over the last six quarters, imports have surged about $30 billion, while exports have declined -- driving a wedge between the relatively healthy growth in spending and the anemic growth in production.

We are contending with growth below trend in part because of the maturing of this expansion. Typical in the early part of the economic recovery, pent-up demand for housing, consumer durable goods, and business equipment -- along with a need to restock inventories -- led to a spurt of growth. After adjustment to higher desired inventories, most spending rates declined in line with income growth. Consumer spending has been a disturbing exception, however. This uneven pattern is not uncommon -- several other postwar expansions have had periods of slow growth after the first few quarters. However, the degree of slowdown this time has been unusually pronounced, again in part due to the rapid deterioration of the U.S. trade balance. Since the second quarter of last year, real domestic spending has increased nearly $67 billion, but real domestic production has increased only about $50 billion. Thus, about one fourth of the growth in spending has been siphoned off by the growing trade deficit. Importantly, the megadeficit in trade has kept some sectors of the economy -- including agriculture -- in a virtual depression.

The strong dollar has also had some positive aspects. It has helped keep U.S. inflation at one of the lowest rates in two decades, only about 3¼ percent so far this year, foiling forecasters who foresaw higher price increases. Contrary to previous experience, inflation has continued to decline into the third year of this expansion. An unusually large degree of slack has remained in labor and product markets for this stage of the business cycle, keeping wage increases moderate and allowing businesses to improve their profits without large price hikes.

The Inflation Outlook for 1986

What about the inflation outlook for next year? I remain optimistic. Commodity prices have represented deflation. Some indexes of raw commodity prices have declined about 20 percent since early last year, and some of these price declines have not yet shown up in consumer prices. Moreover, there is excess capacity world-wide for most raw commodities. And since many commodities are produced by lesser developed countries (LDCs) in need of dollars to service debt, production rather than prices is likely to respond to any pickup in the world economic growth rate, if one should occur. Despite some recent seasonal increases in prices for petroleum products, those prices are expected to begin falling by next spring. Overall, a surge in commodity prices is unlikely to be a source of inflationary pressure next year.

Neither is there a clear danger from labor costs. Compensation per hour has increased only 4 percent in the past year. Yet, this modest gain has outstripped productivity gains, leading to some increase in unit labor costs. I expect productivity to pick up somewhat over the next year due to improvement in corporate-management structures forced by intense foreign competition and to the increased use of computers and telecommunications equipment. Wage gains may remain moderate, resulting in a smaller advance in unit labor costs next year.

The decline in the exchange value of dollar could be an area of concern for disinflation. From its peak in February, the dollar has declined nearly 25 percent -- much of that since the "Plaza" G-5 accord in September. Based on historical relationships, this dollar depreciation could raise consumer inflation by about 1¼ percentage points over the next three years. But I expect the effects to be somewhat smaller this time around. Profit margins are unusually wide for foreign firms that compete for market share in the United States. These firms are not going to sacrifice market shares readily, so they may absorb a large share of the dollar depreciation before raising prices.

More importantly, the Federal Reserve's sustained commitment to disinflationary monetary policy has strengthened our credibility as an inflation fighter. Survey evidence shows that expectations of inflation over the next five years have trended downward. But expectations are notoriously fragile, so our credibility must be maintained through policies that are effective in sustaining growth without reinflation. It won't surprise you when I say that we are determined to pursue such policies!

Overall, I expect only a slight acceleration of inflation next year. Moreover, it will be due predominantly to cyclical and temporary factors. I am confident that the core rate of inflation will remain below 4 percent -- so the temporarily higher inflation need not be embedded in market interest rates and wage contracts.

The Economic Outlook

I must admit that I am less confident about the consensus forecast for real economic growth. Major policy decisions that will shape the economic outlook have yet to be completed and implemented. Thus, there are risks to continued economic growth stemming from certain questions about the policy background for the U.S. economy next year. One can even imagine a set of policy choices that could lead to a recession next year. Indeed, there is some possibility of recession even if economic policy is supportive of continued expansion.

Weighing the risks indicates that the most likely outcome, though, is for the continued moderate economic growth so necessary for long-term improvement in the health of the economy, especially the agricultural sector. Agriculture has the most to gain from economic policies that guard against recession.

Before describing in more detail the scenario I think most hopeful -- and most likely -- let me first outline an alternative that gives greater weight to the downside risks for agriculture and for the general economy.

One scenario for recession could begin with an impasse in the ongoing efforts to reduce Federal budget deficits over a multi-year horizon and continued uncertainty about the timing and structure of tax reform. Some market makers would then see continued high interest rates resulting from massive budget deficits and deep uncertainty. Higher interest rates would push against recent progress toward realistic exchange rates. Strains on LDC debtors, thrift institutions, and agricultural lenders would be reinforced. We simply cannot tolerate a scenario involving a turndown in the U.S. economy. Any stalling of the U. S. expansion could lead to renewed calls for protectionist legislation, intensifying any downward spiral in world output and agricultural exports.

How can we avoid this pessimistic scenario? A good start would be agreement on a credible program to reduce U.S. government spending and thus budget deficits. In my view, such an agreement could unleash consumer and investor confidence that would lead to healthy economic growth without reinflation. It would do so in part by short-circuiting the latent protectionist sentiment that is the single most dangerous threat to continued economic growth. It would also allow a further decline in real U.S. interest rates and dollar exchange rates.

With this optimistic policy scenario, some might expect that economic growth next year will match the 4.3 percent rate reported for the third quarter. I am not that optimistic. The relatively rapid third quarter growth was built on shifting sands -- it resulted from temporary factors that do not provide a basis for sustainable growth. One major factor was a sharp rise in spending for autos induced by concessionary financing, which obscured a slowdown in spending for other goods and services. Another was the large increase in government spending, which accounted for two-thirds of the third quarter rise in GNP. Part of this increase was due to payment for defense contracts that have been in the pipeline. There is already some evidence that increases in defense spending are winding down to levels consistent with the Congressional budget resolution for fiscal year 1986. A second source of "strength" in the third quarter was the large Commodity Credit Corporation purchases of agricultural products. You would agree that weakness in agricultural prices that led to the sale of agricultural products to the government is hardly a plus for the long-term economic outlook.

Now for a paradox: government spending will actually tend to be a drag on economic growth next year! I know it is hard to imagine that, with a budget deficit near $200 billion. But remember, it is the rate of change rather than the level of government spending and budget deficits that counts in measuring the impact of fiscal policy. After increasing at a rate of over 12 percent over the last two years, real Federal government purchases will likely decline next year.

Indeed, the fiscal drag on the economy might be large enough to cause a major slowdown were it not offset by improvement in another component of aggregate demand, our trade balance. After deteriorating rapidly this year, real net exports may improve somewhat next year. The substantial decline in the dollar in recent months will make U.S. goods more competitive. For those of you in America's premiere export industry, there is light at the end of the tunnel. Unfortunately, we have dug ourselves a tunnel so deep that its end will remain distant. But at least the post-Plaza U.S. economy has begun to move in the direction of greater balance and sustainability.

One factor that may prove not to be sustainable, however, is the growth of consumer debt. Household debt as a percent of disposable personal income recently has reached an all-time high of over 75 percent. Moreover, consumer debt has grown faster than consumer assets for about two years. This debt is especially burdensome because real consumer borrowing rates are at historically high levels. This issue obviously is a crucial one for the economic outlook.

Although personal, corporate, and governmental debt levels do raise serious questions about the sustainability of continued strength, there are some factors that make the situation somewhat less worrisome. First, deregulation of financial markets has made increased interest income available, helping to offset the burden of high interest expenses. Second, the expanding use of credit cards for convenience rather than for credit has biased upward measures of consumer debt. Third, the expansion of outstanding consumer installment debt is consistent with historical relationships between borrowing and consumption, on the one hand, and debt repayment and the outstanding debt, on the other. Finally, consumers are coping. Delinquencies have risen only slightly so far. Despite these mitigating factors, the consumer debt situation is one that bears watching.

On a more discouraging note, the prospects for business fixed investment appear rather bleak. Surveys of business intentions for capital spending suggest that investment in new plant and equipment will show a modest gain at best in 1986. The most disturbing aspect of this outlook is not its short-run effect on aggregate demand, but its long-run effect on aggregate supply. U.S. producers can remain competitive in world markets and U.S. living standards can improve over time only if business -- including agribusiness -- finds it profitable to expand the stock of productive capital.

The Policy Setting

It is possible, of course, that passage of a tax reform bill would improve the investment outlook for next year, though subsequent year effects could be negative. Incentives for some types of investment, such as commercial construction, might be reduced in the short run -- and none too soon, in my view, given the massive overbuilding in office buildings. But removing the uncertainty about tax treatment for capital expenditures actually could lead to somewhat stronger investment spending in 1986.

A more important short-run fiscal policy would be agreement on a multi-year plan for reducing federal budget deficits. A credible plan to reduce budget deficits, especially if slanted toward lower spending rather than higher taxes, could have a dramatic and favorable impact on consumer and invester confidence. The high real interest rates and overvalued dollar have been the factors most responsible for the imbalances that threaten the sustainability of this expansion. You have felt the effects in the agricultural sector; so have those in the manufacturing and mining sectors. Trade protectionism won't help for long. Nor will sector-specific government programs. The only way to restore vigor to agriculture, manufacturing, and other depressed sectors is to achieve real interest rates and exchange rates consistent with a more balanced economy. Farm policy hasn't caused declining prices for agricultural land and agricultural commodities; budget policy has. So the fate of agriculture is tied to the prospects for reducing deficit spending.

Regardless of the budget policy outcome, monetary policy will do its part to sustain economic expansion. The Federal Reserve has gained credibility through its policies to reduce inflation while sustaining growth: this without rigid adherence to monetary growth targets when financial innovation, deregulation, and other changes make inflexibility inimical to achieving ultimate policy goals. The downside risks in the outlook reinforce the need for the Federal Reserve to implement monetary policy flexibly.

In my view, our decision to rebase the M1 target range for 1985 and our subsequent decision not to react aggressively to M1 growth above our rebased target have enhanced the prospects for sustained economic growth. The aberrant behavior of monetary velocity could have led to an abrupt end to this expansion if we had insisted on achieving our monetary growth objectives at any costs. We did not do so. To contribute to the management of the risks that exist in the U. S. and world economies, the Federal Reserve must continue its flexible approach to monetary policy. If you will pardon the expression, the stakes are too high, in the agricultural and other major sectors, to put all of our eggs in one monetary basket.

What role M1 will play in our policy implementation next year remains to be seen. Although it slowed somewhat in October, M1 growth has been extremely high most of this year despite the sluggish economy and modest inflation. The resultingly large -- and to some extent unexpected -- decline in its velocity has cast doubt on the present usefulness of M1 as a target for monetary policy. A recent study at the New York Fed concluded that velocity is likely to remain unpredictable. If so, we may continue to deemphasize M1 and rely on the eclectic approach adopted this year. Whatever our operating procedures, though, the Federal Reserve will make every effort to do its part to keep the economy on track through a fourth year of expansion.

Conclusion

In summary, I think the chances are reasonably good for continued economic expansion without reinflation. There are a number of downside risks, however. Many of these risks result from uncertainty about fiscal policy -- both with regard to the budget deficit and tax reform. With the fragile state of the financial system and a base of subpar economic growth for several quarters, it is not certain how long the economy can continue to cope adequately with this uncertainty. If fiscal policy issues are resolved by early next year in a way that supports balanced economic growth, prospects are reasonably good that the U.S. economy can continue expanding in 1986.