OUTLINE ONLY
NO PREPARED TEXT

THE ECONOMIC OUTLOOK FOR THE NATION

Remarks by Robert P. Forrestal
President and Chief Executive Officer
Federal Reserve Bank of Atlanta

To the National Association of Business Economists, South Regional Roundtable
Atlanta, Georgia
July 13, 1992

Introduction: I am very pleased to have this opportunity to talk with members of the Southern Regional Roundtable of the National Association of Business Economists as you meet here at the Atlanta Fed. Today I would like to speak with you about where the U.S. economy is headed, particularly in light of the recent economic news and the reduction in the discount rate on July 2. Beyond that, I would also like to make some observations about the difference between forecasting and policymaking.

Since you are economists, I plan to talk about some potentially sensitive topics that I do not normally address with less knowledgeable audiences. For that reason, I would like to keep my comments today completely off the record, meaning that I do not want to see them cropping up in any newspaper quoted secondhand. (But then, given the uncertainty of the economic projections in the current environment, I suppose many of you would prefer not to be quoted on your former forecasts.)

I. Short-term Economic Outlook

A. GDP: More slow growth on both the near and far horizons after a respectable gain of 2.7 percent in the first quarter.

B. CPI: Price pressures continue to abate. This circumstance put the Fed in the position of being able to make some monetary policy moves that would not have been possible in times of high inflation.

C. Employment: This is the one indicator causing the most problems right now. We are simply not seeing the kind of improvement in labor markets that I expected, and I am quite disappointed.

1. I was particularly unhappy about the recent employment data. Apart from the 7.8 percent unemployment rate in June--which can be partially explained away by seasonal factors, such as the great numbers of teenagers looking for jobs--the fact that the economy lost more than 100,000 payroll jobs was extremely disquieting, to say the least.

2. My interpretation of the situation is that business seems tenuous about the economic outlook. That attitude is leading to higher productivity gains, but lower job creation.

3. Without jobs, the simple fact is that many people cannot afford to buy houses or cars, which in turn, depresses the purchase of durable goods.

D. Behavior of money supply

1. Another concern in the near-term besides the employment data has been the money supply.

   a. Earlier, M1 had been growing rapidly.

   b. But during May and June, M1 fell along with M2 and M3.

2. Although I do not use M1, M2, or M3 as guides for short-run policy decisions, it seems to me that we must get a bit nervous when all the aggregates are going down.

E. This somewhat negative economic news does not, however, mean that I am calling for anything like a double- or triple-dip recession. The economy seems likely to continue expanding, albeit moderately.

II. Fed's Response to Economic News

A. While the Fed does not create jobs directly, we can try to create an atmosphere that encourages a sustainable business expansion, one that is not characterized by price pressures as it moves ahead.

1. One method at our disposal is to lower the discount rate, which we did again on July 2. The discount rate is now at its lowest level since 1963.

2. One difficulty in gauging policy, though, is that changes in inflation--either up or down--take a long time to develop. They lag behind changes in economic activity by a considerable margin.

B. While this observation about the long-term horizon of monetary policy is hardly novel, it is important to remember that this is the first time in memory that the Fed has had to "go it alone," both during an expansionary period and a contraction. During this recession, fiscal policy has been notable by its absence. This void is significant because government spending and tax policies can spur consumption and create jobs almost at once. This situation is putting an undue amount of pressure on monetary policy to stimulate the economy--something it was never meant to do on its own.

C. Still, I believe that a modest economic expansion is under way and that the recent easing moves taken by the Fed should help to ensure that this growth is sustained.

D. The present situation is appreciably different from last year when an incipient recovery did not take hold.

1. There has been progress in alleviating imbalances and constraints to growth over the past 12 months. For instance, household and corporate debt have been worked down, and balance sheets are in better shape. While restructuring--with its attendant pains--could continue for a while longer, it is creating a stronger base for expansion.

2. Some mild pent-up demand had a chance to develop over an additional year of weakness.

3. Lower interest rates are encouraging consumer spending and improving corporate cash flow.

III. Analysis of How We Got to Where We Are

A. Most of you are generally familiar with how we got into this fix, but I think it is important to have a very clear understanding of this process if we are to draw useful lessons from the painful experiences of this recession. These lessons apply not just to the distant future but also to the present situation and the manner in which we move beyond it.

1. Aside from demographic shifts, the current slow pace of the recovery arises in large measure from the complex transition businesses and households are going through now in response to past decisions that led to an increase in debt and an overly expansive economy in the 1980s. In the

1980s, we had:

a. A large defense build-up

b. Tax policies that encouraged excessive real estate development

c. More generally, the ongoing stimulus of large federal budget deficits.

2. Also, throughout the '80s, Americans did not invest enough. As a nation, we consumed more than we produced and went into debt.

3. Now we must service that debt, much of which is owed to foreigners, since we lacked the domestic savings to meet our financing needs.

4. To support the debt service, our exports are growing faster than our imports.

   a. That is, what we are sending abroad for others to use is growing faster than the growth in what we are consuming domestically.

   b. We are producing more, but enjoying it less--or, more precisely, enjoying less of that increase.

B. Why did we take on so much debt as a society?

1. Many households and businesses became used to the high inflation of the 1970s and early 1980s.

2. In such an environment, debtors are winners because they can pay back what they owe in "cheaper" dollars.

3. Now that inflation has diminished, though, businesses and consumers are scrambling to de-leverage in order to reposition themselves for a less

inflationary economy.

C. More fundamentally, Americans trusted too much in growth for its own sake.

1. We hoped we could grow our way out of problems like poverty, affordable housing, and health care. As it turned out, this hope was not well founded.

2. Moreover, we handicapped ourselves during the recession by allowing huge federal budget deficits to eliminate fiscal policy as a countercyclical tool.

D. As I mentioned, the picture is not completely bleak.

1. Balance sheets have been improved as households and businesses have reduced their debt.

2. Consumers and companies have learned the painful lesson of going through such wrenching adjustments and are not likely to take on so much debt anytime soon.

3. Major sectors of the economy are downsizing--retail, airlines, banking--and becoming more productive in the process.

4. Beyond U.S. borders, good things happening in Latin America with its development; stellar performance in newly industrialized countries of Asia; and EC 1992 promising for lowering of trade barriers.

5. I am very confident that with the moves in the discount rate, the economy will be able to sustain a reasonable--though not spectacular--rate of growth.

E. Still there is the risk that the expansion may not feel like one to many people.

1. For instance, though 2 percent growth seems good to economists, business people may not be happy because their profits and revenues are disappointingly low compared with earlier numbers, especially during the high-growth years of the 1980s.

2. We cannot return to the status quo ante.

3. The danger is that as a society we seem too impatient or, at least, inconsistent. We have come to recognize the folly of using debt to finance consumption, but we are not completely ready to come to terms with prospects of limited growth.

4. I think that this unwillingness has a lot to do with our short-term focus as a nation.

IV. Policymaking vs. Forecasting

A. At the beginning of my remarks, I mentioned I would comment on the difference between policymaking and forecasting. I wanted to do so because it points up this issue very clearly.

1. It is my belief that public policymaking should be more long-run in nature.

2. This is not true for forecasting, particularly if one forecasts for businesses, which are generally more worried about the next quarter.

B. I am not finding fault with forecasters or businesses.

1. After all, many of the incentives of the private sector in a market system work to achieve continuous adjustment, seizing profit opportunities as they

arise, adopting new techniques, and so forth. Without these traits, U.S. businesses would become as ossified and sclerotic as the former socialist economies of Russia and Eastern Europe.

2. The fundamental goal of policy in a market system must be to create a hospitable environment that will sustain business activity in the economy as a whole over time. An important ingredient in this process is the element of certainty. Without it, business cannot achieve the necessary mix of short-run adjustments and long-run investments.

C. This difference in function is reflected in methods and data.

1. Methods that are good for forecasting often contain little in the way of information that is helpful to policymakers.

2. For instance, a lagged function used by forecasters may predict what auto sales will be next month, but it does not reveal how the economy is working or whether GDP is growing.

D. This distinction, I think, lends an insight into the current debate on policy, particularly when forecasters are prominent among those asking the perennial question, 'Why isn't the Fed doing anything?'

1. The fundamental answer is that policymakers must face the problem of accounting for the lag in inflation that I spoke of earlier, while forecasters need not.

2. If policymakers were to become fixated with the next quarter's growth, we would be ignoring the most basic lesson from this difficult period--that

unsustainably rapid growth today simply borrows from the aggregate consumption of tomorrow.

Conclusion: In conclusion, let me reiterate my belief that this expansion will be sustained. As we look to the long run, we have more challenges to face in coming to terms with how we allocate our resources to strengthen the economy. But I hope we have learned that our failure to invest creates problems later on and that the current balance sheet restructuring reflects this realization. We need to commit resources to development as opposed to pushing short-term growth. Only this way can we preserve the foundations of a growing economy that will take us into the 21st century with a sense of confidence and vigor.