THE U.S. ECONOMIC OUTLOOK
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It is indeed a pleasure to be able to speak at this weekly luncheon held by The Exchange Club of Nashville. I am familiar with the tight ship you run to get your speakers on and off, since I am a member of the Atlanta Rotary Club. So with no further ado, let me move onto my topic today: the U.S. economic outlook for both the short term and the long term. I will not be discussing any specific numbers on growth because the chairman of the Federal Reserve, Alan Greenspan, testified before Congress this morning on this very subject. My views are consistent with his, so if you would like to have more detailed numbers, I refer you to his testimony. For that reason, I will concentrate more on analysis in my talk today.

Short-term Economic Outlook

To begin with the outlook for the rest of this year, I think we can expect more slow growth after a respectable gain of 2.7 percent in gross domestic product (GDP) during the first quarter. The operative phrase, though, is 'moderate, slow growth.' As a central banker, I am always concerned with the rate of inflation. Therefore, I am pleased to say that price pressures continue to abate. Employment is the one area causing the most problems right now. We are simply not seeing the kind of improvement in labor markets that I expected. As you know, the unemployment rate in June increased to 7.8 percent. This jump can be partially explained away by seasonal factors, such as the great numbers of teenagers looking for jobs. Nonetheless, the fact that the economy lost more than 100,000 payroll jobs was disquieting, to say the least. 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.

The problem is that without jobs, many people cannot afford to buy houses or cars. This dilemma, in turn, depresses the purchase of durable goods. This somewhat negative economic news does not, however, mean that I am calling for anything like a double- or triple-dip recession. Rather, I think the economy seems likely to continue expanding, albeit moderately, and that the recent easing moves taken by the Fed should help to ensure that this growth is sustained. Let me briefly explain the three reasons why I think the present situation is appreciably different from last year when an incipient recovery did not take hold. First, 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. Second, some mild pent-up demand had a chance to develop over an additional year of weakness. Third, lower interest rates are encouraging consumer spending and improving corporate cash flow.

Fed's Response to Economic News

Notwithstanding these positive signs, the moderate growth prospects and disappointing employment figures have caused many to call for further policy stimulus--some fiscal, some monetary. Unfortunately, fiscal policy has been absent as a policy tool in this downturn because of the huge federal budget deficit build-up in the 1980s, and I see very little change on the horizon in that regard.

As for the Fed, we do not create jobs directly. Still, the central bank can try to create an atmosphere that encourages a sustainable business expansion, one that is not characterized by price pressures as it moves ahead. One method at our disposal is to lower the discount rate, which we did again earlier in July. That put the discount rate at its lowest level since 1963.

There is, however, a significant difficulty in gauging how accommodative--or restrictive--monetary policy should be; namely, 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. 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. As I mentioned, 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.

Long-term U.S. Outlook

Let me now turn to an overview of the longer-term prospects for growth in the United States and the dynamics underlying this outlook. Although the Federal Reserve does not make formal forecasts over an extended time horizon, a variety of factors suggest that the United States will be growing more slowly in the 1990s than it has in recent decades. The longer-run potential for growth is now closer to 2 percent than to the 2 1/2 to 3 percent that we experienced on an annual average basis from 1950 to 1980.

The modest rate of the anticipated growth arises in part from demographics. We will have fewer people entering the work force in the 1990s than we did in the 1970s and '80s. In the late 1970s, for example, some 3 million people entered the labor market. In contrast, last year fewer than 1 million people sought jobs for the first time. The sharp drop in the growth of the U.S. labor force translates into lower demand for new housing, for automobiles, and for many other products. Aside from altering our immigration laws, there is very little public policy can do about the adverse impacts of this demographic change on aggregate demand. We could, to be sure, make up some of the difference by selling more to consumers abroad. However, in a fundamental sense these demographic changes limit our capacity to grow by limiting our labor resources. We all know that labor is perhaps the single most important factor of production.

Of course, the number of workers is not the most critical dimension. Rather, it is their productivity that counts the most. However, prospects here are mixed. U.S. productivity in manufacturing has improved substantially, but such gains have not been forthcoming in the other sectors of the economy. One reason is that, as a society, we have not invested as much as we should have--particularly in education and infrastructure. We are simply letting too many people enter the working world ill-prepared, or unprepared, for the demands of the modern workplace.

Another closely related factor underlying the slow growth trajectory for the rest of this century is the huge debt that is burdening the nation. As a result of the debt buildup, businesses and households are being forced to make a painful transition. Of course, there is nothing wrong with debt per se. Borrowing is a standard means by which businesses expand, and there is no theoretical basis in finance or economics for selecting the optimal amount of debt versus equity. Unfortunately, during the 1980s rather than investing as much as we should have, Americans consumed more than we produced and went into debt. This penchant toward debt occurred in all sectors of the economy--households, businesses, and especially the federal government, which began to run massive budget deficits. Now we must service that debt. Moreover, much of that debt is owed to foreigners since, as a nation, we lacked the domestic savings to meet all our demand for financing. To support the debt service, we are exporting a large share of our output; that is, what we are sending abroad for others to use is growing faster than the growth in what we are consuming domestically. We are producing more, so to speak, but enjoying it less, or more precisely, enjoying less of that increase.

Why did we take on so much debt as a society? In my opinion, many households and businesses had become used to the high inflation of the 1970s and early 1980s. In an inflationary environment, debtors are the biggest winners because they can pay back what they have borrowed in "cheaper" dollars. In fact, though, inflation has diminished, as I noted at the outset. As this change became apparent in the late 1980s, businesses and consumers began scrambling to de-leverage in order to reposition themselves for a less inflationary economy.

More fundamentally, however, I believe that Americans trusted too much in growth for its own sake. In other words, there was a widespread view that we could simply outgrow many of the problems that were plaguing us--poverty, affordable housing, health care, and the like. It was thought that if such growth required a catalyst of debt, the resulting benefits would outweigh the costs. Moreover, solving these problems through growth would avoid having to make tough choices between competing social causes. Unfortunately, the problems did not go away. Poverty, for one, has persisted and perhaps has become worse. At the same time, we have handicapped ourselves from dealing with these issues through the huge federal budget deficits that have virtually eliminated the tools of fiscal policy.

Lessons to be Learned

Now all of this analysis sounds pretty bleak, but I do not want to draw an overly pessimistic picture. There are, to be sure, some positive developments in the offing. As I mentioned earlier, balance sheets have been improved considerably as household and corporate debt have been worked down. No family or firm is likely to forget--or repeat--the painful memory of this adjustment process anytime soon. In addition, major sectors of the economy are making fundamental changes in the way they do business. In the service sector, for example, many firms are downsizing. This shift is particularly apparent in retailing, airlines, and banking. These firms are becoming more productive in the process, and that development bodes well for the economy over time.

Looking beyond the borders of the United States, I am also optimistic about developments in Latin America. The policy reforms that were implemented in the latter part of the 1980s are beginning to yield returns. Growth rates are up and inflation is down. Moreover, healthy demand for a variety of U.S. exports by countries south of the border is already helping to offset the effects of the relatively weak economies of our major trading partners. Since these changes in the Latin American countries reach to the very structure of their economic and political systems, their effects should be long lived.

In addition, the United States, Mexico, and Canada may enter a North American Free Trade Agreement, which will enhance commerce and other interchange significantly among these three neighbors. Likewise, Europe 1992 holds very auspicious long-term implications, not just for Europeans but for all countries. The substantial lowering of trade barriers that will begin at the end of this year will certainly cause some adjustments and even dislocations for inefficient producers. Nonetheless, overall output should expand more rapidly than it would have without the major reforms undertaken by the European Community. Finally, there is the continued stellar performance among the newly industrialized countries of Asia. On balance, then all of these developments suggest that American businesses that take the initiative to export will find good market opportunities abroad.

However, these positive developments are merely opportunities, not a forecast of business activity. Certainly the United States has come to export more as a percentage of GDP. In fact, the share has risen from 4 percent in 1960 to 8 percent in 1991. Imports have gone from 3 percent to 9 percent over this period. However, small and medium-sized U.S. firms are not as export-oriented as are their counterparts in Europe. Moreover, we have seen a troubling rise in protectionist sentiments that, if successful, could negate these hard-won gains. Americans must do a better job of taking advantage of trade opportunities just as we must do a better job of dealing with the federal budget deficit and related macroeconomic problems.

Overall, though, the economy should be able to sustain a reasonable--though not spectacular--rate of growth during the 1990s. The main risk to this forecast is that as a society we seem to be too impatient. Whereas two percent growth seems adequate to economists, many 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. Similarly, it may not "feel" like much of an expansion to consumers, especially those who went on a borrowing and buying binge in the 1980s. I think we have come to recognize the folly of using debt to finance consumption, but, as a society, we are not completely ready to come to terms with prospects of limited growth. If we do not develop a longer term perspective, the result could be a repeat of past mistakes. I can only hope that we will profit from the hard lessons of this recession and support policies that foster lasting growth, not just growth for the next quarter.

Conclusion

In conclusion, let me reiterate my belief that this expansion will be sustained, but the U.S. economy is not likely to grow as fast on average during the 1990s as it has in recent decades. Changes in demographics and the adverse effects of large federal budget deficits are constraining our capacity to grow. There are bright spots, however, particularly in the realm of international trade.

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. Still, I am somewhat optimistic. The current balance sheet restructuring, in my view, reflects the realization that our failure to invest now creates problems later on. We need to commit resources to development as opposed to pushing short-term growth. Only in 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.