THE ECONOMIC OUTLOOK FOR THE UNITED STATES
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It is a pleasure to be here today to speak with you about the outlook for the U.S. economy. Before I discuss the broader economy, I would like to make a few comments about the economy of Florida, colored by my knowledge of growth in other states in the region. The most telling economic fact of life in this state is that the rate of growth in payroll employment, about 3 percent, is greater than the 2-1/2 percent equivalent growth in the nation. In practically any terms, this rate of growth is healthy. The problem is that many Floridians simply are not happy with 3 percent growth because it is less than the more than 4 percent growth achieved following Hurricane Andrew.

Four percent-plus growth was indeed deliriously good, but not sustainable for the long term. Even though the growth rate has diminished, I would like to point out that, by comparison with Georgia, the sheer number of new jobs created is impressive: Georgia payrolls grew at a rate of more than 4-1/2 percent from April 1993 to April 1994, and the state added 140,000 jobs. However, at a lower rate of growth during that same period, Florida added 200,000. In short, Florida is the giant of the Southeast that sometimes does not appreciate its own strength.

Here in Jacksonville, a growth rate slightly lower than the rest of the state may contribute to a sense that the area is underperforming other metropolitan areas in the state. In fact, while

that is true, it is important to bear in mind that some of those areas, such as Miami, added more jobs in one year than did the whole state of Mississippi. However, let me remind you that Jacksonville is performing as well as the nation as a whole in terms of job growth. This performance would be welcomed by many other large metropolitan areas in the United States, particularly in the Northeast or on the West Coast.

Longer-Term Outlook Update

With that in mind, I would like to review a few of the strides we have made as a nation in laying the groundwork for steady, long-term growth in the United States. First, inflation is noticeably lower than it was at the beginning of this decade when it stood at 5-1/2 percent. Through a judicious use of monetary policy, the Federal Reserve has managed to engineer the lowest inflation in many years. I do not have to explain to this audience how important low inflation is to the world of commerce and trade. However, the need to resist inflation is as strong as ever. I will have more to say on this topic later on in my remarks.

Another promising factor for continued economic growth is a more highly productive work force. We have reached this level of high productivity not without a good deal of pain, but I am convinced that the investments businesses are making today will create greater opportunities for growth in the future. During the past several years, many consumers and businesses worked hard to successfully reduce their leverage, and this also bodes well for the future. In addition, businesses slimmed down cost structures and made significant commitments to realizing gains from automation. We are just beginning to see this process yield fruit, and we will continue to do so over many years.

Not only the private sector but the public sector as well has become more mindful of debt levels. Last year, we finally saw some movement toward containing the size of the federal budget deficit, thanks to the fact that the Administration and Congress agreed on a deficit-reduction plan. Finally, in the area of international trade, the North American Free Trade Agreement (NAFTA) made it through Congress, and the compromise on the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) was finally struck. As a believer in the necessity of free and open trade to promote long-term growth, I fervently hope that these two achievements will not be seen as final steps, but rather as steps in the right direction toward global free trade as it is being promulgated in GATT.

The U.S. Economy

I would like to turn now to the economic outlook for the United States. My discussion begins with three key measures of economic performance--output, inflation, and employment. For the nation as a whole in 1994, I believe the economy should continue to grow a little more than 3 percent as measured by gross domestic product (GDP). Inflation, as measured by the consumer price index (CPI), should increase between 2-1/2 and 3 percent this year. Earlier declines in oil prices, productivity gains, and ongoing import competition are keeping prices well behaved in the near term. Unemployment should move down to about 6 percent toward the end of the year.

Looking ahead into 1995, the U.S. economy should grow at a slightly slower rate than in 1994. Unemployment should continue to fall below the 6 percent mark. That leaves inflation, which may rise further to slightly more than 3 percent.

The main strength supporting this outlook lies in consumer spending, especially on durable goods like autos and household appliances, but there are other strengths. Residential construction will also continue to make a solid contribution to growth, while contributing to strength in related areas, such as home furnishings, at least in the near term. As we move into 1995, though, much of the pent-up demand for housing will have been met, and residential construction should begin to decelerate naturally. The purchases of consumer goods should support continued growth in manufacturing. Finally, capital spending by businesses, especially on computers and industrial equipment, should remain vigorous. The lagged impacts of the relatively low interest rates of the last few years--even though rates have moved up recently--are a factor in all of these areas. Recent employment gains should also provide support for further increases in personal income and consumer spending. On another promising note, imbalances have been worked down substantially on corporate balance sheets, due largely to the earlier declines in interest rates, the lengthening of debt maturities, and equity issuance. Banks and real estate firms are also stronger.

To be sure, there are also specific areas of weakness in the economy: commercial construction, government spending, and international trade. Office construction still suffers from overbuilding in previous years, but I believe that we are beginning to see a modest upturn. While state and local purchases will grow, government spending overall will be weak because expenditures at the federal level are being affected by defense cutbacks and deficit reduction. Of course, I do not view this "weakness" negatively because deficit reduction is long overdue.

The third negative factor--although not so negative as it was last year--is the outlook for

net exports, which has been poor due mainly to the weak economic conditions of many of our largest trading partners. The situation abroad, however, has begun to reverse itself, and some western European economies, such as Germany, have begun to round the corner. This stronger growth abroad, combined with the impact of the weaker dollar, may slow the deterioration in real net exports for the rest of this year and may lead to actual improvement in 1995. In the meantime, the main source of growth in exports will come from Latin American countries, Canada--our largest trading partner--and Asia, excluding Japan. Computers, telecommunications, and other capital equipment, as well as services, should remain the leading exports. In fact, our leadership in technology bodes well for the future. At the same time, though, imports will continue to grow faster than exports as the increase in U.S. spending still outstrips that of many of our trading partners.

These weaknesses notwithstanding, the risk in this outlook is not whether the U.S. economy can expand. Rather, it is the possibility that too rapid and thus unsustainable growth will ultimately contribute to rising inflation--an outcome the Federal Reserve most assuredly wants to avoid. Therefore, the Fed began in February to shift away from the accommodative monetary policy stance we had had for some time.

Certainly, we recognize that the globalization of the U.S. economy helps to dampen domestic price pressures. However, the economy has been growing at a rate in excess of its long-run potential, thereby running the risk of constraints on capacity. This situation often leads to inflation. Early in a recovery period, this is not a problem, but, as the gap between actual and

potential output narrows, central banks begin to become concerned that the momentum will push an economy through its capacity constraints. Although there have not yet been any signs of accelerating inflation at the retail or output level in the United States, the pressures that can lead to it are there. With the current course of monetary policy, the Fed wants to make sure that inflation will no longer be a problem in the United States. In that light, it is critical for us to fend off inflation before it starts recurring.

Now, it may seem to many people that the Fed spends too much time worrying about inflation, particularly since the economy is healthy now, and inflation seems to be quiescent. However, an important point to remember is that the costs of inflation are significant. One reason for having an independent central bank is that it allows us to take a longer view of the economy. This long-term vision is especially important when dealing with inflation because price increases accelerate with a long lag. At the same time, I am not so single-minded as to believe that we must achieve zero inflation immediately or that we necessarily have to reduce inflation at every stage of the business cycle. As I see it, there are always trade-offs to be made when trying to bring inflation down. Businesses, labor, and consumers must be given time to adjust their financial behavior in light of changing economic policy. Too quick an adjustment can cause too much pain, and I personally believe policymakers must be attuned to these social costs.

Uncertainty in the Markets

At this point, I would like to discuss two topics that the publisher of the *Jacksonville*

Business Journal, Don DePerro, asked me to cover today: interest rates and financial markets. Although by the time I am through you may wonder whether or not I really discussed these topics, my plan today is to give some insight into the role of the Fed in regard to interest rates and financial markets rather than to go into details. Part of the reason is that the chairman of the Federal Reserve, Alan Greenspan, may be responding to questions on these very subjects as he testifies this morning in the House of Representative about the state of the economy. He did the same two days ago in the Senate. As you might imagine, Fed watchers everywhere are closely following what news reporters put out on the wire services to see what he is saying, even as we have been eating lunch, in fact. Their purpose is to see if they can spy the one word or nuance of a phrase that might give them a sense of how monetary policy might evolve over the next few weeks or months. All of this sort of analysis of what the Chairman says and how he says it leads to the false impression that the Fed has secrets it is keeping from the rest of the nation.

The fact is, central bankers influence interest rates based on what we think is going to happen in the economy. Moreover, the information to which we have access is, by and large, the same as that available to everyone else. We do have staff that analyzes the information, but, like all econometric models, those they use have limitations as forecasting devices, even though they can be revealing about linkages. Such models may often get the direction of changes in the economy right but, typically, they have more difficulty with the timing of the changes. If we became confident of a change in the economy, then we would act; there would be no reason to wait. If our analysis led us to believe that the economy will overheat, then we would tighten monetary policy, causing interest rates to move up. If our analysis led us to believe that the

economy will weaken, then we would act to loosen monetary policy, causing interest rates to fall. If we were more uncertain than certain, then we would wait.

The point about uncertainty is an important one. Statistics are useful but not definitive. They usually reflect what has happened months before rather than what is happening in the economy now--much less what will happen in the future. But the Fed must always be looking ahead to ensure that the policies of today have an appropriate effect in the future. That is by no means an easy task with the way well-lighted. It is more like a dim corridor. Uncertainty is what darkens the way. So, in regard to interest rates, the Federal Reserve does not have a working crystal ball, and, therefore, we cannot know the future. Neither can we remove, or even significantly reduce, this uncertainty. Therefore, we do not want to mislead people and give them the impression that we can. In this circumstance, being careful with what one says is not the same as keeping a secret.

I have also been asked to talk about financial markets. The big question on the mind of everyone is, What is going on in the financial markets? I am sure that members of Congress are questioning Chairman Greenspan right now about this very same topic. They probably want to know what the financial markets are telling us and why they seem to be so unsettled. Now if I were perspicacious enough to know what the markets would do, I would probably also be wise enough to leave the Fed for the greener pastures of Wall Street and make my fortune there. Unfortunately, I have never found the key to the markets, and I believe I am not alone in my misfortune.

Even though I cannot say exactly where the markets are headed, I can say something about why they are so unsettled. In my opinion, the story is pretty much the same as it is for interest rates: Uncertainty causes volatility. Market participants are more uncertain than usual about the future, and thus they tend to respond more than usual to incoming data. Also, if they expect inflation to worsen, this concern in itself would add to fluctuations in market prices. Although the markets have been quite volatile of late, they remain liquid and deep. We do have the most highly developed markets in the world. Moreover, I would not want a particular institution or product (such as derivatives) to be blamed for creating volatility in them. Besides, I believe it is only fair to point out that, in the last few years, investors have reaped far more capital gains than losses in the financial markets.

Conclusion

To sum up my outlook for the U. S. economy, the economic expansion is proving to be quite strong this year. As I mentioned earlier in my remarks, the risk in this outlook is not whether the U.S. economy can continue to expand, but whether growth that is too rapid and unsustainable might ultimately contribute to inflation. In this regard, I can promise that the Fed will remain ever-vigilant. However, with the steps we have been taking as a nation to deal with difficult long-term problems, such as the deficit and international trade, I also believe we are putting in place the components for stable, long-term growth.