THE ECONOMIC OUTLOOK FOR THE UNITED STATES AND MONETARY POLICY CONSIDERATIONS

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Emory Chapter of Omicron Delta Epsilon
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I am delighted to be invited to speak at your annual induction dinner for new members of Omicron Delta Epsilon. Your faculty advisor has taken the liberty of advising me--not so much about my career opportunities--but as to your interest in policy issues. He also mentioned that some of you might even be thinking about working at the Federal Reserve. Of course, I would like to encourage that kind of thinking because the Federal Reserve is always looking for the brightest young minds to add to our excellent staff of economists and analysts.

At the Federal Reserve Bank of Atlanta, for instance, we have a research staff made up of 18 economists, most of whom have their Ph.D.s, and about the same number of analysts and interns who have either bachelors or masters degrees. The staff is divided into three teams that cover different aspects of economics and policy: macroeconomics, regional economics, and finance. Other divisions in the Bank also hire people with an economics background. For instance, over the years many economic analysts have transferred to the Supervision and Regulation Department, where they work on issues ranging from lending discrimination to the implications of repealing the Glass-Steagall Act.

Although I am sure some of you would like to know more about real job possibilities at the Federal Reserve and elsewhere in the economy, my intent this evening is to give you a sense

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of the relevance of economic research to an institution like the Atlanta Fed. Economists spend much of their time conducting basic or theoretical research on topics ranging from the term structure of interest rates to the interaction of monetary and fiscal policy and the effects of ambiguous information on financial market behavior. Tonight, I would like to describe the discussions of a central policy issue regarding inflation expectations prompted by some of our staff economists. All the research done at our Bank is aimed at helping me in my role as president of the Bank and our directors as we help to set monetary policy for the nation. I am of the belief that a description of how economic research can be used in the real world will be more useful to you in the long term than a rundown of existing job opportunities, which you can more easily get from your own on-campus resources.

The U.S. Economy

But before I turn to that discussion, I think it would also be useful for future economists to hear my outlook for the national economy. Growth in output last year was 4 percent, and this year also looks like another good year, but with somewhat more moderate growth of 3 percent or possibly a bit higher on an annual average basis. I might add that, considering that the expansion has been going on for nearly four years, this rate of growth in 1995 would also be more appropriate. With growth decelerating, it is unlikely that the unemployment rate will decline much further. My best guess is that it will average between 5-1/4 percent and 5-1/2 percent. Inflation may rise to somewhat above 3 percent, since price pressures tend to increase as the economy operates at or near capacity.

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As has been true the past few years, the main areas of strengths and weaknesses in the U.S. economy will not change much in 1995. Certain components of gross domestic product that have been growing strongly through 1994, such as personal consumption, capital spending, and construction, will still be growing--but at a slower rate. Healthy demand for automobiles and other durable consumer goods accounted for much of the acceleration in personal consumption last year. Sales of automobiles and other durables will be good again in 1995, but they will not provide as large a boost to the economy as they did in 1994. That deceleration is the result of increases in interest rates that have occurred. Also, pent-up demand has largely been met. Consumption of nondurable goods like clothing will continue to grow, but not enough to offset the expected slowing in demand for consumer durables to a pace that is more sustainable.

The same theme holds true in the area of investment by businesses in productive capital, such as plant and equipment. Capital spending has been growing in the double-digit range for two years now. Although this investment will be decelerating, this retreat is from a very high pace. I would like to add that this aspect of growth is quite significant. That is because it expands the capacity of the economy, a matter which is quite vital at this time when we seem to be near or at our capacity--whether measured in terms of the unemployment rate or factory use. This rapid addition to productive capacity helps to temper price pressures from strong demand and is reflected in the inflation forecast.

Another type of investment spending, construction of single-family homes, has contributed strongly to economic growth in the United States over the past few years. This boom in building

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activity has now peaked. Although multifamily and commercial construction should be increasing in 1995, these anticipated increases will not offset the decline in single-family construction.

Government spending is likely to be flat after shrinking somewhat last year. Even in the face of the defeat of the balanced budget amendment, the ongoing pressure to reduce the federal budget deficit should help to keep government spending down. Of course, it is hard enough to make economic forecasts. I am certainly not going to attempt a U.S. political forecast, especially this year. Still, any changes that the new Congress might enact are not likely to affect economic activity directly in 1995, although they could indirectly affect expectations as reflected in financial markets. Let me emphasize also that, although government spending will not add to GDP, any progress toward reducing the deficit will be good for the long-term prospects for economic growth.

Looking at that part of our economic growth that is affected by foreign trade, I can say that the gap between exports and imports should begin to shrink this year after several years of growing larger. However, this is not to say the deficit will go away. The United States has been growing relatively faster than its traditional trading partners. In turn, the demand for imports in the United States has increased faster than the demand abroad for U.S. exports. Fortunately, the signs point to a narrowing of this trade gap this year, as the U.S. expansion slows and the pace of economic growth picks up in Europe. Additionally, the ratification of the General Agreement on Tariffs and Trade (GATT) will set a more positive climate for U.S. trade, although I do not expect a substantial impact in 1995. On the negative side, the Mexican peso has depreciated

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dramatically in recent months. This development, along with the institution of more restrictive economic policies in that country and possibly others in Latin America, will probably restrain demand for U.S. exports from those areas. In addition, with the high value of the yen, economic growth in Japan may not pick up as quickly as was thought possible earlier in the year.

So, to recap briefly, in the United States this year, GDP should grow by about 3 percent, with inflation rising to somewhat above 3 percent, and unemployment averaging between 5-1/4 percent and 5-1/2 percent. Although it is true that some areas of the U.S. economy may be slightly weaker than in the past year or two, overall the economy will be very healthy.

Two Views of Inflation

As promised at the beginning of my remarks, I would like to turn now to some work on an important economic policy issue put forth by the Atlanta Fed staff that may contribute to our understanding of inflation. Although I do not subscribe to this view because it has not been proved, I believe that raising this issue is useful because it addresses the question of how the Federal Reserve can make good policy over the longer run.

For quite a while now at the central bank, we have appropriately focused our concern on reducing inflation. This approach was developed at a time when core inflation was far too high and had become embedded in expectations. The process of bringing inflation down involved slower economic growth than would otherwise have been the case. It also involved a willingness to risk recession over much of the period in the early 1980s. This toughness was persuasive. As

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a consequence, I believe that these policies worked and that people began to think and act as if inflation was less of a threat than before. If so, now may be a good time to reconsider our policy strategies as we go forward from here. The principal issue we need to deal with is whether or not the economy is less inflation-prone than it was in the recent past, and that is the area some Atlanta Fed economists have addressed.

Before I describe their arguments, though, first let me give you some background on the prevailing point of view on inflation. This view suggests that the wage and price behavior of the 1970s and 1980s has not changed in the 1990s. Its central theme is that once there are small price pressures in the economy, then general and accelerating inflation will inevitably follow. If enough people believe in this view of price pressures, then it actually becomes difficult to fend off inflation because their prophecies, so to speak, become self-fulfilling. The reason is that people will take pre-emptive actions, such as increasing the prices at which they sell their goods and services (including their own labor), to protect themselves from anticipated pressures in the prices of goods and services they purchase. Since buyers of goods and services also believe this, they will agree to pay the higher prices. In so doing, they generate widespread price increases.

Another tenet of this widely held point of view is that expectations regarding inflation have changed very little over time; so that, once things get started with some small price pressures, it is difficult to stop them from increasing indefinitely. This prevailing view of inflation also suggests that relative price increases do not draw more resources into the market. That is, across the business cycle, demand grows but supply does not respond sufficiently. The

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implication of this view is that strong action by the Fed is the only way to break this cycle of inflationary expectations.

While this viewpoint is a credible one, it also has serious risks. If inflation is not as entrenched as some might suggest, then strong efforts to resist it may lead to economic slowdowns or losses of output that could possibly be avoided.

The approach that my staff has raised with me suggests a different way of looking at wage and price behavior. The starting point for their analysis is that the economy is less prone to inflation than it has been in the recent past, in part because the expectational setting has changed. Think about it this way: The Fed has been fighting inflation for more than 15 years--a time during which a generation of Americans came to expect recurring inflation at some point in a business expansion. But the Fed succeeded in bringing inflation down, even during the current expansion. It would therefore seem likely, the argument goes, that this success would have implications beyond the mere fact that inflation is the lowest in 30 years. One implication might be that actions by the Fed have changed the economic environment by weakening the very forces that in the past may have led to generalized inflation. Stated simply, the history of policy and its success may have contributed to changing expectations about inflation.

Another argument cited for believing the economy is less prone to inflation comes from the observation that overall demand may not be growing more rapidly than supply. Reinforcing this view is the fact that growth in productive capacity has been stronger in comparison with

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growth in consumption than in previous economic expansions. For example, the growth in producers' durable equipment investment has been very strong compared with the growth in consumption during this recovery.

The possible change in expectations I referred to a moment ago may be manifested in changes in price-setting behavior, according to this argument. For example, ordinarily, when the unemployment rate has dropped to a relatively low point, it means that workers have some leverage in demanding higher wages. Now, however, even with the unemployment rate considerably below 6 percent, workers may be in less of a position to argue for higher wages than they were in the past. For instance, after the large-scale restructuring many industries have gone through, a good number of white-collar workers who lost their jobs went into business for themselves as consultants. Although they are counted as employed, it is probably safe to say that a high percentage are underemployed. Many of these consultants would no doubt prefer to be working at a large corporation again with all the standard perks, such as health insurance and a corporate pension plan. Therefore, even though they are counted as employed, they may be competing for permanent, full-benefit jobs as though they were unemployed. In addition, the continuing news in the media of yet more downsizings by major firms also causes workers to be less eager to demand higher wages.

In view of these arguments, it is possible that we are not necessarily condemned to repeat the past. My staff points out that, if indeed the Fed has achieved some credibility in its fight against inflation, it might be reasonable to believe that this credibility has affected people's

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expectations about inflation and also their behavior in setting prices. This perspective suggests that relative or cyclical price pressures need not inevitably lead to general increases in the price level and that the recent low level of inflation will not accelerate indefinitely but rather play out as the cycle matures. In other words, heightened price pressures might be viewed as largely cyclical in nature, rising and falling with the ebbs and flows of overall economic activity, albeit with a lag.

The problem as I see it is that, like the prevailing view of inflation, this point of view also carries significant risk: If the economic environment has not, in fact, changed, but policy does change, then the country may very well experience more inflation than would be necessary. This risk is very serious because the costs of inflation are high.

What Might This New Approach Mean for Monetary Policy?

Now let me discuss how these two points of view then represent the horns of my dilemma as a policymaker. If policy follows a method of dealing with inflation that does not take into account the possibility that the economic environment has changed, then we may run the risk of growth that is slower than it would otherwise be. If policy for dealing with inflation is changed based on the belief that the environment has changed, there is the costly risk of allowing more inflation to develop and once again paying a high price to bring it back down. To compound the problem, there is no objective way for me to learn whether the record of Fed policy over the past 15 years has actually changed the way people think about inflation. And, of course, the burden of proof rests on those who believe that things have changed.

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However, for the sake of argument, let me pursue my staff's analysis a bit further and ask, what would be the role for monetary policy in a new economic environment? Or put another way, how would the Fed act if the economy were less prone to inflation than before? The obvious answer is that the Fed would not have to repeat the same strong actions that were necessary earlier, when we needed first to bring inflation down and then to convince people that it was not going to be allowed to rise again to such high or lasting levels. The Fed would not have to "go to the wall," so to speak, to quiet inflation fears--something that may have been necessary when we did not have sufficient credibility. As a consequence, we would probably also be able to contemplate reducing the inflation peak in each business cycle with less risk of an economic slowdown than before.

Conclusion

In conclusion, economic research contributes a great deal to the formulation of monetary policy in our nation. Even if I do not presently believe in the approach to inflation that members of my staff have outlined, that does not mean that it may not become the prevailing view someday. There are many applications for the discipline of economics--from careers in business to the law to public service. Perhaps some of you in this room tonight will contribute the kind of useful research that helps policymakers like me provide for a healthy economic environment in the United States. Whatever your future endeavors, know that your studies have honed your analytical skills, and these will serve you well no matter what career you choose. Moreover, as citizens and voters, you are better trained than most to make wise choices in regard to many public policy decisions. Let me close by wishing you the best as you pursue your interest in economics as well as your own economic interests.

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