

## Speeches

### The Outlook for the Economy and Reflections on Fed Policymaking

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Over the past year, I've had the opportunity to address business audiences throughout our southeastern region--from the hills of Tennessee to the coast of South Florida--but having the chance to be here with you today is a homecoming of sorts. I spent a total of about 10 years of my Fed career here in New Orleans, at three different times over the last 30-plus years.

I was especially pleased to have André Rubenstein introduce me because he served a total of eight years as a director of our Bank, first as a New Orleans Branch director for two years, and then on our Atlanta Board of Directors for six years. And, from that experience, he knows firsthand how much we depend upon grassroots economic information from people like him and others throughout our region.

A big part of my job is to help people understand what the Fed is thinking and doing, and why--and to be out with real business people and community leaders, to understand what you are thinking and what you are expecting from the economy. That's why I'm pleased to be here with you today.

What I want to do with my time today is to reflect a little on what's been going on in the national economy over the past five to six years and, in doing that, share my view on where I think it's headed. After that, I plan to talk very briefly about how the regional and local economy is doing. And then I'd like to tell a couple of stories--one true and one not true (at least in my view)--that I hope will help to explain the Federal Reserve's recent monetary policy action that has gotten so much press attention and is being talked about most everywhere I go. And finally, if there's time, I'd be delighted to see if I can respond to your questions on things I've talked about or other things you know we're involved with at the Fed.

#### Economic Outlook

These last six years, since the recession in 1990-91, have been extraordinary. Actually, as economists measure economic expansions, we're into the seventh year of this expansion, the third-longest since World War II. Real GDP growth since this expansion began in 1991 has averaged almost 3 percent annually (2.8 per cent, to be exact). The current unemployment rate of 5.2 percent is the lowest since 1989, and we've been around this very low level for some while now. We've had inflation at or below 3 percent (as measured by the CPI) for four consecutive years--or as some of the broader measures would have it, around 2 percent. These broader measures are consistent with the recent conclusions of the Boskin Commission, Fed economists, and others who suggest that the actual inflation rate may be as much as 1 percentage point lower than currently reported by the CPI.

Over the past couple of years, various people have described the situation as a Cinderella economy, or a Goldilocks economy (not too hot, not too cold, but just right), or they have compared it to the Energizer bunny, as it just keeps on going. Economic expansions don't have to die of old age, but more often than not inflation and resource constraints of one kind or another eventually begin to bring trouble. We're now nearly one-third of the way through 1997, and I expect to see continued moderate growth--with more low inflation and low unemployment. But I also expect to begin seeing some slowing in the pace of activity as we move through 1997. We got the first official report on first-quarter GDP growth just this morning, and it confirmed that the economy has been growing faster than most of us expected as we began this year. It now looks like 1997 could exceed last year's 2-1/2 percent annualized growth, assuming there are no big surprises over the rest of the year. Where's the strength behind this growth coming from?

**Consumer spending** is leading the way. We've all seen the reports of month-after-month strong job growth--and income growth has been strong as well. Although the volatility of the stock market in recent weeks has probably had some impact, the "wealth effect" (as economists call it) from the run-up in stocks and other assets is thought to have added to consumers' willingness to spend. We have not really seen an imbalance in consumer spending, though, and, in fact, spending is currently growing somewhat less than income, while the savings rate is increasing. Debt burdens are somewhat higher but not yet at the level of past peaks. Needless to say, if the savings rate begins to fall again, or we see consumers starting to spend even more on the basis of their perceived wealth, this would be a concern.

**Housing**, which is particularly important to the economy of the Southeast because of our various industries that feed off of it, has been slightly stronger for longer than we had forecast. Nonetheless, I am still expecting some slowing in housing over the rest of 1997 and into 1998, not only because of the slightly higher long-term interest rates but also more fundamentally because of demographic trends. There simply aren't as many new families looking for apartments and houses as there were in the 1970s and 1980s.

**Business spending** looks like it will continue to be a source of strength again this year. While investment in plant and equipment is not now quite as robust as it was earlier in this period of expansion, everything I see and hear suggests businesses will continue to spend on productivity-enhancing equipment. When the history of this period of economic expansion is written, I think one of the big stories that will be told is how a new era of competition (some of it global) has pushed businesses of all kinds to invest in more and more technology to produce their products or services at a lower unit cost.

Another place where we see pretty good balance is in **inventories**, which appear to be about in line with desired levels--although they are at much lower levels than we have seen in the past due to new inventory management techniques, such as just-in-time inventory, which are now used in almost all industries.

**Government spending** should remain flat overall if Congress can make some very difficult decisions and come up with a plan to reach a balanced federal budget. Although such a plan would reduce the upward push of federal spending, increased spending at the state level would partially offset its effects.

**Demand from abroad** is not likely to change dramatically in the period immediately ahead and should continue to be a moderating force, given that the prospect for

economic growth of our major trading partners remains only moderate.

So you see, we do continue to have a pretty balanced economy. At the same time, I would point out that it seems to me that the greatest risk going forward is on the upside, and the largest upside risk is in the area of consumer demand--which accounts for about two-thirds of GDP. As I mentioned earlier, job growth continues to be quite strong, and with it has come good growth in spendable income. And with consumer confidence at very high levels, it doesn't appear that demand is likely to slack off any time soon. A quick review of past economic expansions tells us that most expansions don't quit because consumers as a whole decide to slow down their spending, but instead what usually happens is that consumers want to spend even more. And, as they do, aggregate demand continues to increase until it outstrips supply--and if such an expansion is fueled by accommodative Fed monetary policy, eventually we get an overheated economy and an accelerating rate of inflation.

It was a fresh assessment of this risk, and others that my colleagues and I on the Fed Open Market Committee saw, that caused us to make a modest monetary policy tightening move at our FOMC meeting about four weeks ago. And, in the aftermath of that policy move, the Fed is getting even more attention (and press). Before I go on to talk about this interesting topic, let me take a quick look at the outlook for the regional and local economy.

### **Regional and Local Economic Outlook**

During the first several years of this business expansion that began in 1991, the Southeast outperformed the nation in terms of payroll growth. There are several reasons for that. One big story for the Southeast has been the ongoing move of the auto industry (domestic and foreign) to Tennessee, Alabama, South Carolina, and Georgia. The Olympics gave an added boost to Atlanta and other southern cities in 1995 and 1996. And, as I mentioned earlier, home building is big business in our region, and as is typically the case in the early years of a business expansion, our region benefited as that industry and others that feed off of it caught up with pent-up demand.

Louisiana's pattern of growth recently has happily been closer to the national average than had been the case for several years. Our sense is that your state's economy also has a better chance now than in some past periods, but clearly the pick-up in the energy sector is an important factor. What's particularly good about this area of strength for the state's economy is that it's not coming from a temporary, \$40-a-barrel boom in the price of oil. Instead, we understand this strength is being driven by technology that is helping to improve drilling extraction. Since this kind of growth isn't caused by temporarily high oil prices, it appears to be sustainable. Granted, improvements in your energy sector are probably helping the rest of the state more than New Orleans, but even New Orleans is benefiting from growth in oil-service jobs.

**Shipbuilding** is another area that is doing very well all along the coast, and those who work at the Avondale shipyard are seeing firsthand the rewards of this industry's health. This growth in shipbuilding is also helping to pick up what little slack there is in construction jobs to the extent that construction workers have any transferrable skills.

It is our sense that the **gaming industry** is doing well throughout the state, except in New Orleans.

**Tourism**, that key part of the local New Orleans economy, is down a little, and there are a few ways of looking at the situation:

1. As economists say, it could be seen as a purely technical correction, in that this city's hotels have been at nearly 100 percent capacity for a long time. Technically, it's just not realistic to think that the hotels can do a whole lot better than the high rate of bookings they've been doing.
2. Alternatively, you could also say that it's difficult to interpret the numbers and to know whether total tourism is really off or not. For example, New Orleans has added a lot of capacity, so occupancy rates are down, even though there are still a great number of tourists visiting the usual tourist spots. But the problem is, it's almost impossible to know how many tourists the city missed when it was at operating capacity. So it's really not easy to say whether tourism is actually up, down, or even.
3. You can interpret, better than I can, how crime and perception of crime are affecting your tourist industry. I can tell you what we learned from the experience of South Florida, the other big tourist destination in this region, that bad publicity about crime does take its toll. The good news that can be taken from Florida's experience is that a determined effort to get at the root of problems that discourage tourists can turn around a tarnished image. It's my understanding that you've already undertaken some aggressive actions to protect and enhance your reputation as one of the great tourist destinations.

### **Inflation Stories**

Now, I'd like to turn from these thoughts about the local economy to the larger issue of how the Fed is handling monetary policy. When I was a young father, some years ago now, one of the greatest pleasures in life was to crawl up in the bed beside my "young'uns" and read them stories until they fell off to sleep. As my children have grown up and left home to start their own careers (and have their own babies), I'm being exposed to a new form of story telling--that's when the economists on my staff tell me stories to support their interpretation of the current economic data and economic developments. And believe me, those stories aren't nearly as interesting as those children's bedtime stories were.

But, having said that, let me engage in a little economic story telling myself.

### **Story Number 1**

There are some popular stories about how the Fed should be handling inflation being told by the press and others who have strong views about what's going on in the economy. Here's how these stories might sound if they were boiled down into one version:

"We've got a vibrant economy with strong job growth and no measurable increase in inflation. The Fed is supposed to worry about things other than inflation--like job growth--so 'dadgummit,' the Fed should keep its hands off of interest rates. We like things just the way they are."

This is a very understandable way of looking at the world, and even my own characterization of the current economy could lead one to honestly believe we've made it to the Economic Promised Land and can live happily ever after. In fact, I hear from a lot of business people--including a few at a recent meeting of the Small Business,

Agriculture, and Labor Advisory Council--that they can't understand why the Fed seems to be so anxious to take action against something they can't see.

But to those who would have us wait until we "see the whites of inflation's eyes," (and by that I mean wait until we've had several months of deteriorating inflation data) before we begin to move to a more restrictive policy, to those people I would only say, look at what our past experience has been under such an approach (and we've certainly tried that before--knowingly and unknowingly). We have learned from experience that when we wait too long it takes a bigger dose of medicine of higher interest rates to bring things back to a sustainable rate of growth. And such greater swings in the economy do not engender the kind of confidence I talked about earlier, the kind of confidence that encourages business people to invest in job-creating plants and equipment and consumers to stay on a sustainable course of spending.

Indeed, because of the lags in the way monetary policy decisions are played out in the economy at large, waiting for concrete and indisputable evidence of inflation virtually guarantees that we will always be behind the curve, acting too late. Essentially, the Federal Reserve has to do its best to look months ahead and take pre-emptive actions against the possibility of accelerating inflation. While I think we do get some immediate "psychological reaction" and change in behavior to a Fed policy move--easing or tightening--the major effects of any interest rate change take months and months to work their way through the economy, lags that are thought to be at least nine months or a year or more. Clearly, our policy action a month ago reflects what we think the economy will look like later this year and into next year.

## Story Number 2

So now let me talk about why we did decide to slightly tighten monetary policy at our latest FOMC meeting. Here's the story the Fed told at 2:15 p.m. on the afternoon of March 25:

"This action was taken in light of persisting strength in demand, which is progressively increasing the risk of inflationary imbalances developing in the economy that would eventually undermine the long expansion."

In talking about the risks to the economy earlier, I have already told part of this story more informally--the old Economics 101 relationship between supply and demand. Excessive demand pressures show themselves in different ways in different economic cycles. Sometimes it's capacity utilization that moves beyond its practical limits, and we begin to see delays in deliveries and, eventually, prices being bid up. This time around, it's been the availability of labor that has been under the most pressure. We've been seeing it in the statistics and in the anecdotal reports we've been getting from around the country that tell us the task of finding the next 10 or the next 100 workers has become more and more difficult. You see it almost every month when the unemployment numbers come out!

Let me take a few seconds to talk briefly about the idea that there is a fully predictable link between the level of unemployment and inflation. There is a fairly common argument that runs like this: as unemployment declines, labor resources become scarce. Wages then get bid up, and these increased labor costs get passed through to consumers in the form of higher prices--all of which result in accelerating inflation. Although this line of reasoning may sound logical, it's not always that simple for at least two reasons.

**First**, wage increases and prices aren't always necessarily linked. For example, if labor productivity is increasing, then companies can pay workers more and still not affect their profit margins or feel the need to raise their product prices. In fact, if the very large investments we've been seeing in productivity-enhancing equipment yield savings greater than any increase in labor costs, then some companies may even be able to increase their profits--again, with no necessary implications for prices.

**Second**, higher costs can be passed through only if customers are willing and able to pay the higher prices. The only situation I'm aware of in which wage increases can result in higher prices is if there is too much money chasing too few goods, as the old saying goes. That usually means that the stance of monetary policy is so accommodative that it actually encourages wages to be bid up and enables them to be passed on to consumers. When this is the case, then wage increases will follow from accelerating inflation rather than leading to inflation.

That's why the Fed must always keep its eye on the "inflation ball." The problem we face today as policymakers is to sort out whether any wage increases are being justified by increases in labor productivity--or whether wage increases instead are coming from robust demand for goods and services and are serving as an indicator that monetary policy is too loose and is allowing inflation to accelerate.

As a final note on this story, I think it bears repeating that this kind of vigilance regarding inflation is essential to realizing the economy's fullest growth potential. It comes down to the notion that when businesses have confidence that inflation will remain low, they are more willing to make the kinds of investments that raise productivity and real growth over time. In that sense, it's not a choice between low inflation on the one hand and job growth and good economic growth on the other. Low inflation brings with it the other good things that all of us want out of our economy. And let me reassure you that I as much as anyone want to see this expansion continue so that it beats our last record of just over 100 months--we're at 73 months and counting right now.

That's enough stories and general economic talk for now. Let me stop with the expressed hope that when the final chapters of the current economic story are told that we have managed to extend the current economic expansion for more years--and that any future swings in the level of economic growth in this country were more modest than if we had simply let nature run its course.

Thanks for the invitation to be with you and to share these thoughts. If any of you would like to know more about what the Atlanta Fed does in this region, you can pick up one of the Annual Reports I brought along with me today. Thanks for your interest and attention.

## CONTACTS

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