

## Speeches

### The 1998 Economic Outlook for the United States

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Thank you, Dave.

As Dave indicated, he was recently named Chairman of the Board of Directors of our Atlanta Fed. That means that, in addition to providing oversight on how we manage the Bank and providing me economic intelligence and policy advice, Dave is also charged with providing generous, on-the-spot introductions for the President of the Bank. I'm certain that Dave has sat on enough boards in his career to know which of these responsibilities is most daunting.

Most of you have sat through enough "First Monday in January" addresses from me, Bob Forrester, Bill Ford, and even Monroe Kimbrel (for some of you who go way back) to know that sharing our Fed economic outlook with our Rotary Club early each year has been a tradition for quite some time now.

Before I do that today, I'd like to say thanks to the many of you who have become part of my informal "kitchen cabinet" of economic advisors. I enjoy being out in the region sharing my thoughts as to what the Fed is seeing and doing, and why. I get some tough audiences, but none more astute than this one. With you, I have to face 52 weeks of follow-up questions.

The old Chinese expression, "May you live in interesting times," has been understood as both a blessing and a curse. I doubt the scribe was an economist, but I think he coined the perfect description of the U.S. economy for 1997.

Final numbers aren't in yet, but it looks as though 1997 was a year of superlatives:

It was the sixth consecutive year of growth in an expansion that started in April 1991. That makes this the third-longest expansion in the post-war era, and we're still counting.

It was a year that saw real GDP grow at an annual rate of about 3-3/4 percent, the highest rate of growth since 1988.

It was a year that saw inflation as measured by the Consumer Price Index grow at a little less than 2-1/2 percent, the lowest since 1986.

And, it was a year in which the unemployment rate averaged about 5 percent, the lowest since 1973.

Now, it's not unusual for one economic performance measure to be exceptional in a single year—low inflation in a recession year, for example, or very fast job creation early in a recovery. What's truly remarkable, however, is that all this good news came in the same year and on top of five previous years of steady GDP growth, low inflation, and a declining jobless rate.

The explanation may be familiar: Spurred by increasing competition and abetted by technology, businesses made unprecedented investments in capital and training. Those investments paid off in 1997: productivity rose more rapidly than it has in years. As a result, employers were able to increase compensation while containing unit labor costs so that profitability was maintained or improved—the best of both worlds for shareholders and workers. Meanwhile, strong employment and wage growth supported income, and this, in turn, boosted consumer spending—the cornerstone of overall demand. All in all, it was a virtuous circle, unlike the vicious cycles we've occasionally known in the last 25 years.

Sound fiscal and monetary policies helped create this economic environment. The balanced budget agreement reached by Congress and the Clinton Administration was the latest in a series of actions that helped reduce the fiscal year 1997 budget deficit to less than \$23 billion—the lowest since 1974—and a vast improvement over the \$107 billion 1996 deficit. The budget agreement sends a clear signal that consumers and businesses—and not governments—will be the primary economic decision makers in the coming years. As for monetary policy, I think it's sufficient to say that low rates of realized inflation and ongoing Fed vigilance have nearly eliminated inflation as a major concern in business decision making. Low inflation also encouraged the productivity-enhancing investments that are so important to the virtuous circle I just described.

In short, strong job growth and consumer confidence, sound business investments, and prudent fiscal and monetary policies all combined to make 1997—truly—one for the record books.

Now, for those of you keeping score on me—no, I did not foresee such an unprecedented year when I gave you my 1997 outlook last January. I told you I expected GDP growth between 2 and 2-1/2 percent, an unemployment rate around 5-1/2 percent, and inflation at about 3 percent. Maybe it was partly the central banker in me that helped cause me to err on the cautious side: I was high on inflation and unemployment and low on GDP. I never expected our steady, reliable Ford Taurus to turn into a speedy—but safe (non-inflationary)—Corvette.

Looking ahead, I expect that 1998 will be another good year, if not the benchmark that 1997 was. I look for GDP to continue to grow, but at a more moderate pace than in 1997: I think around 2-1/2 percent on an annual average basis. Inflation should remain in the low range of the last several years, likely around 2-1/2 percent, as cheaper Asian imports provide more competition for U.S. goods and monetary policy keeps a lid on overall prices. Labor markets should remain tight: I think unemployment in 1998 will likely average about 4-1/2 percent, near its current level. The outlook is similar for the Southeast—slower but very healthy growth ahead in most states and sectors. We have to keep in mind, however, that this somewhat slower growth I'm expecting will be from a very high 1997 base.

Many of you will recall from Economics 101 that national economic output—economists call it gross domestic product or GDP—is the sum of consumer and business spending, government purchases, and net exports. Without belaboring the details, here are the highlights of what I expect in each area in 1998.

**Consumer spending** should continue to grow at a healthy—though more restrained—clip. Frankly, this was one of the big surprises of 1997. At this point in an economic expansion, growth in consumer spending usually slows down, especially for durable goods like autos. It didn't happen last year, however. Income growth, tight labor markets, low interest rates, and a healthy economy encouraged consumers to spend more. Those favorable underlying conditions remain as we begin 1998, but I still believe that the rate of growth in consumer spending will decline slightly as consumers resist borrowing and maintain their spending more in line with income.

The major caveat in the consumer sector is **debt**, which remains very high relative to income. I should emphasize that there are no signs of a consumer debt crisis. Still, less borrowing and more saving would allow consumers to manage a little better if income and employment growth slow more than I expect.

**Business investment** spending should also remain healthy in 1998. Here again, 1997 was a surprise. Businesses usually invest heavily in the early years of an economic expansion. As an expansion ages, capital spending often pauses while demand catches up with new, on-line capacity. Last year, however, demand was high enough to support continued strong investment. We also know that a large share of investment spending was motivated by the desire to contain wage costs and address labor shortages. Businesses substituted capital for labor, which is exactly what you would expect in a tight labor market. This should continue into 1998. Tight labor markets, salary pressures, and stiff domestic and foreign competition should encourage continued strong investment spending in 1998, but at a lower pace than last year.

My major concern for business—as it was last year—is **tight labor markets**. Companies have been very resourceful so far—hiring retirees, for instance, making greater use of more flexible contract workers, or even recruiting high school students for post-collegiate careers—but I remain concerned about the limited supply of workers. As a policymaker, however, I should note that tight labor markets in the absence of inflation are a good thing, because they indicate rising standards of living.

As for **government spending**, my staff and I believe 1998 will actually see a contraction at the federal level and only a very moderate increase at the state and local level. While I welcome the restraint that the balanced budget agreement will bring to discretionary spending, I was disappointed that it failed to address either the Social Security problem, which is bad, or the Medicare program, which is even worse. These two programs account for more than one-third of all federal spending. And over the last year, many of us in public policymaking positions have sounded the alarm over the growing drain these programs will add to federal spending as baby boomers age and retire. We ought to take the entitlement medicine now, while our healthy economy can help us stomach the resulting political indigestion. If we don't, the balanced budget and fiscal restraint we are now experiencing will evaporate.

As for **exports**, I can't dispute what you've no doubt heard already: a stronger dollar and weaker Asian economies will exacerbate the U.S. trade deficit in 1998. And, yes, slower Asian growth will dampen U.S. GDP growth, and lower import prices will help keep inflation low. But I think it's important to realize that U.S. exports should continue to increase: we think by at least 8 percent. The problem is that imports will almost certainly increase even faster.

A couple of things to keep in mind: First, exports are equivalent to just 11 percent of U.S. GDP. Second, only 13 percent of U.S. exports go to Hong Kong and the six Asian countries hardest hit by the current downturn: South Korea, Thailand, Indonesia, Malaysia, the Philippines, and Singapore. This amounts to just over 1 percent of U.S. GDP. None of this is to suggest that exports are unimportant. The larger point is that the Asian crisis matters to the United States for many more reasons than exports.

I'll discuss in a moment some of the lessons to be drawn from the so-called Asian flu. I'll argue that the virus itself—quite apart from its well-known symptoms—is actually industrial policy. And while I'm not worried that we'll catch the Asian flu here in the United States, I do see a few distressing signs of economic amnesia.

I'm speaking, of course, of the failure to extend "Fast Track" negotiating authority to the President last year. It's one thing to reject a trade agreement because it concedes too much. But it's quite another to refuse to sit down at the negotiating table. Yet this is exactly what the United States did last year with Chile—a country whose economy is less than 1 percent the size of ours. I hope Congress will reconsider Fast Track this year so that we can continue to pursue a policy of expanded free trade.

Suffice it to say, I think the assertion that trade with poor countries makes the United States "poorer" is pure sophistry. It evinces a double standard, since we can't exercise our "comparative advantages" if we refuse to trade with others who would do the same. It's defeatist, since it assumes that we can't compete. It defies economic history, since the United States is still getting richer, even though we trade with all types of economies. And, taken to its logical conclusion, it condemns poor countries to permanent destitution.

The United States should not retreat from world economic leadership. Think of the Marshall Plan, when the United States gave away more than \$13 billion in four years—more than 1 percent of GDP—to 16 war-torn European nations, including several former enemies. Think of the first GATT round in 1947, when American trade concessions exceeded gains by more than 50 percent. Think of U.S. leadership in global intellectual property protection, which has allowed so many American companies to become standard-bearers in software, pharmaceuticals, and other industries. We take it and many other business conventions for granted these days, but they wouldn't exist without us. Does anyone really think we're worse off for our economic leadership?

I realize that no one is suggesting a return to the protectionist Smoot-Hawley era—yet. But I'm concerned that if our trade deficit increases this year, as I think it will, we're going to learn all the wrong lessons and forget all the right ones. What we need to remember is

- (1) markets almost always make the best decisions, even if they're sometimes painful;
- (2) markets are self-correcting;
- (3) regulators can play an important role in ensuring accurate, timely, and unfettered market information; and
- (4) government economic policies must be sustainable in the long run.

The Asian flu illustrates these principles. But first, consider the symptoms. Last year saw the following Asian stock index declines: Japan and Hong Kong, 23 percent; the Philippines, 41 percent; South Korea, 42 percent; Malaysia, 54 percent; Thailand, 57 percent.

The year also saw the following currency declines against the dollar: Malaysia, 34 percent; Korea 41 percent; Thailand, 45 percent; Indonesia, 54 percent. The virus responsible for these symptoms was industrial policy.

Generally speaking, industrial policy happens when the invisible hand of the market is wrested aside by the long arm of the law. It can have several manifestations—and did in most of the Asian flu countries—but at least two were common.

One important element was government-directed investment. In South Korea, it seems that bureaucrats ordered banks to make loans to certain favored companies. More generally, the vital objectivity provided by the arm's-length creditor-borrower relationship was more the exception than the rule.

Currency manipulation was another vital part of industrial policy. In countries like Thailand, Malaysia, and South Korea, emphasis was placed on very high rates of investment and GDP growth, and currencies were pegged at high rates against the dollar. This attracted foreign investors and lenders and encouraged locals to borrow at cheap U.S. and Japanese rates.

But the market couldn't be fooled forever. Foreign lenders eventually got worried about exchange rates and didn't renew some loans. When countries appeared unable to pay foreign debts, local currencies were dumped in the scramble for solid, foreign assets. When currencies fell, real estate and stocks followed. And when that happened, banks collapsed, too. Thus did a currency crisis become a stock crisis, and, finally, a credit and banking crisis.

Japan's situation is different and more complex. There too, however, economic policies contributed to the problem. In particular, inadequate supervision of the financial system allowed banks to make some staggeringly bad loans: American movie studios and real estate in the 1980s, Japanese stocks and real estate in the early '90s, and, more recently, Asian real estate and stocks. Until recently, the Japanese government's response to this crisis has also been unsustainable: it kept banks and brokerage houses afloat in the hopes that an expanding economy and recovering asset prices would finally bail them out. It didn't happen. Still, I'm encouraged that in recent months Japan has finally allowed those financial institutions to close.

The primary lesson is that today's international economic markets will not long tolerate government-directed industrial policies. A secondary lesson is that obfuscation—keeping information from the market—only delays and exacerbates the inevitable.

What does all this mean for the United States? Fortunately, we haven't really embraced industrial policy except—arguably—at the state level. More broadly, we learned from our own S&L crisis about the dangers of inadequate financial supervision and lack of transparency. We've significantly reformed the way U.S. financial institutions are regulated, and we're making progress toward ensuring that market information is available to markets.

The real issue for 1998 could be the internal threat to our post-war economic leadership. The widening trade gap won't affect GDP significantly, but its effects will be more acute for particular industries and regions. I am concerned that these voices of discontent and the voices that shouted down Fast Track will become a protectionist chorus. If that happens, I hope that people like you will speak up about the real causes of the Asian crisis and the right lessons to be learned from it.

I'll close by again recalling the Chinese expression. 1997 was, indeed, one of the most "interesting times" of the decade—in both senses of the term. For the United States, it was a banner economic year; for our Asian neighbors, it was a nightmare. For everyone, it was a reminder that markets can't be fooled for long. 1998 should be another good year but, hopefully, a little less "interesting" in almost every sense. For that, I think we would all be grateful.

Thank you again for the opportunity to share these thoughts.

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