

Speeches

The 1998 Economic Outlook for the United States

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Thank you for that warm introduction, and thanks to your Program Committee for inviting me back this year.

In my two years as president of the Atlanta Fed, I've found that discussing the economy with groups like this is one of my favorite parts of the job. I mentioned this to a colleague at the bank the other day, and he said, "Of course it is, Jack. Look at the economy you've started with. It's like stepping in for Yoel Levi during the fourth movement of Beethoven's Ninth. But just wait until the music stops and your players go on strike. Then see how much you like it." Well, I'm not going to predict that the economic music will stop in 1998, but my colleague's point was well taken.

It is nice to be the bearer of good news, but that's not the reason we in the Federal Reserve System talk about the economy. The Fed is a public institution. It was created by Congress to foster stable prices and sustainable economic growth, and to ensure the safety and soundness of the American financial system. We were not set up as a government agency, but we remain accountable to the people directly and through their representatives in Congress. Chairman Greenspan is required by statute to appear before Congress in February and July of each year to convey the Fed's perspective on the economy and to report on its money-growth objectives. Throughout the year the chairman, the other Fed Governors in Washington and my colleagues and I who are Presidents of the district banks appear before groups like this to discuss the economy and the financial system with some of the people most directly affected by our actions.

I've been at the Fed long enough to know that we have to take the bad economic news along with the good. But I also know that just as we don't deserve all the blame when the economy falters, we also don't deserve all the credit when it performs well.

And for 82 months—since April 1991—the economy has been on a roll. Year-over-year real growth in GDP—gross domestic product—over the course of this seven-year expansion has averaged almost 3 percent, peaking at 3.8 percent last year. The unemployment rate has dropped every year since 1992, reaching a 24-year low of 4.9 percent in 1997 and moving into 1998 at 4.7 percent. And inflation as measured by the consumer price index has remained low, averaging just 2.3 percent last year. If the economy keeps growing—as I believe it will—then by December 1998 the expansion will be the second longest in the post-World War II era.

At the risk of causing some of you indigestion (or at least unpleasant college memories), I think it's helpful to think about the economy's performance in terms of supply and demand. Supply is basically determined by a country's natural resources, workforce and capital. In the short run, that's the number of workers employed and their productivity. Demand is the sum of consumer and business spending, government purchases and net exports. What's happened since April 1991 is that overall supply and demand have grown at more or less the same rate so that, on balance, we have avoided excess demand—which shows up in the economy as shortages—and excess supply, which shows up as unused capacity or as inventories. This balance has allowed output—GDP—to rise steadily, while real prices have increased very little.

A detailed look at the components of supply and demand helps us understand what happened in 1997 and what we might expect this year. But since the Fed tries to influence the economy through demand, let's start there.

Consumer spending accounts for two-thirds of demand and is the single most important driver of GDP growth. Last year saw consumer spending grow at a surprisingly rapid rate, primarily because of strong growth in employment, moderate gains in income and strong levels of consumer confidence. These factors carry over into 1998. I expect, then, that consumer spending will increase again this year, but at a slower rate than in 1997, as spending on durable goods like automobiles subsides after a long period of strength.

My one area of concern on the consumer side is debt, which remains high relative to income. As a central banker, I think of consumer debt as "borrowing from the future," in the sense that consumers can accumulate so much debt—and debt service—for current purchases that they eventually won't have the discretionary income for future purchases. Not only does this act as a drag on future demand, it also limits consumers' range of options if the economy slows down. I should add that we don't yet see any serious problems developing in this area. But every forecast includes a margin of error, and it's my job to worry about the margins, too.

Business spending, which ranges from inventories to office buildings, accounted for about 12 percent of demand last year. Investment in facilities and durable equipment accounts for the bulk of business spending, however, and last year grew over 10 percent; this came on top of two previous years of 9-plus percent growth. Even allowing for a slight deceleration in business investment this year, the current period of investment growth will be the longest in the post-World War II period. As for what's driving all this investment, at this stage it probably has more to do with cutting costs and improving productivity than with expanding capacity. Countering price competition from Asian may be one more reason for businesses to invest this year.

On the residential investment side, lower mortgage rates and gains in employment and wages fueled robust housing activity last year. Demographics should restrain spending on new housing in 1998, but overall residential investment should remain at high levels throughout the year given the favorable affordability of housing. Residential investment accounted for nearly 4 percent of demand last year.

Real estate—commercial and residential—is one of those industries in which we have seen major imbalances develop in past economic cycles. So far in this expansion, the statistics have not indicated any such problems. But in recent months, I have begun to hear the first concerns of speculative overbuilding in some markets. Those cautionary comments have come from developers, lenders and friends in the business; the Wall Street Journal carried a similar story a few weeks ago. I hope those of you in the real estate business will be careful about falling back into one of our old traps.

Government is another sector that was seriously out of balance a decade ago. Fortunately, for 1998, it looks like government purchases will remain flat, growing less than 1/2 of 1 percent when all levels of government are combined, down from around 1 percent last year. However, the fact that government spending has finally plateaued is less significant than the fact that it's finally coming into balance with revenues. Deficits distort the flow of resources to their most efficient uses. The government underwrites many valuable public investments, but a dollar invested in a Treasury bond is a dollar not invested in market-driven projects like the latest computer or biotech innovation. This raises the cost of capital to business. So not having to compete with the U.S. government for investor resources enables business to produce more products more efficiently.

A balanced federal budget also makes life a little bit easier for me as a central banker. The Fed aims to keep prices stable and the economy growing using the tools of monetary policy. These are the discount rate, which we establish by decree, and the federal funds rate, which we influence by our open market operations. Too often in the recent past our policies have been almost predetermined, as overly stimulative fiscal policies kept interest rates high even as inflation came down throughout the 1980s. Now, without the pressure of federal deficits, the full benefits of a low inflation environment can be enjoyed and are more likely to persist for our children's benefit. This is why I mentioned at the outset of my remarks that the Fed doesn't deserve all the credit for the current economy: good fiscal policy and monetary policy together have helped to create today's healthy economic environment. But consumers and businesses deserve most of the credit for taking advantage of these economic fundamentals.

I should add, however, that we're not out of the budgetary woods yet. Social Security and Medicare continue to face enormous demographic challenges. Talk of tax cuts and new spending also makes me uneasy. I really can't put it any better than economist Herb Stein, who served on President Nixon's Council of Economic Advisers during the last Federal budget surplus: "Finding ourselves on a tiny island of surpluses in a sea of past and future deficits, the advice we are getting is to build a swimming pool, not an ark." I join Mr. Stein in hoping that Congress and the president will reject that advice.

The final component of demand is net exports—exports minus imports. Growth in U.S. exports has been one of the big economic success stories of the past decade, but because imports have grown even faster than exports, the net export category has acted as a drag on output growth. An unanswered question for 1998 is whether the Asian crisis will be a small tap on the brakes or a two-footed, brake-locking, skid off the road. Let me be quick to say I expect it will be the former—a modest slowing effect.

The Asian crisis affects demand for U.S. goods in two ways. On the export side, the strong dollar and weak Asian currencies and economies make U.S. exports to Asia less competitive. Frankly, I'm not too concerned about this: the Asian-crisis markets account for only 13 percent of U.S. exports, and, worldwide, I think U.S. exports will grow by around 8 percent in 1988. The second way the Asian crisis affects the demand for U.S. goods is, of course, through imports: goods manufactured in countries affected by the crisis get a lot cheaper, and the strong U.S. dollar buys a lot more of them. For this reason, we know that import-sensitive domestic industries like apparel will face even tougher price competition this year. But the more important economic effect of the Asian crisis is that cheaper imports and slower demand growth will help keep inflation in check in the short run.

You may have seen recent reports that import prices have indeed declined recently. As for when and how much the price of goods will decline at the retail level, it's my hunch—and the empirical evidence on this is decidedly mixed—that consumers may not see the sharp price drops many people are forecasting. For a variety of reasons, price declines at the manufacturer's level may not be as great and may not reach the retail level until much, much later. In some cases, for example, U.S. importers may not try to squeeze every price concession out of their Asian suppliers, in order to protect the long-term economic health of the supplier and the health of the business-supplier relationship. In other cases, U.S. importers might pocket the lower prices in order to rebuild their own margins and profitability. So when the lower costs of imports does begin to pass through to the retail level, it may be in the form of lower price increases, not lower prices.

In short, demand in 1998 is likely to remain strong in the sectors where it matters most—consumer and business spending. Balanced government budgets will be a big plus for private investors. And at the international level, the Asian crisis will mitigate inflation and excessive domestic demand.

But what about supply? If businesses aren't able to accommodate growing overall demand with new supply, growth is stunted. Fortunately, the picture here looks pretty good, too.

At the business and national level, supply growth is determined by the number of new employees and the increase in productivity. As a mathematical equation, that's the change in employment times the increase in output per worker. As I noted in my discussion of business spending, businesses have invested heavily in labor and capital during the current expansion. They've improved production methods, too. All of these things should have improved productivity. Official statistics probably understate the improvement in productivity, but a couple of key facts support this view. Unemployment has dropped to a generational low—4.9 percent last year and 4.7 percent in January. Profits have also continued to grow. Together, these facts suggest that increasing productivity accounts for some of the increase in output. And, in fact, our numbers show that productivity did rise faster at the end of 1997 than it has in years.

My own view is that the substantial investments in capital and training are achieving a marked improvement in productivity. But I worry that some of the new labor coming on line is not as skilled, educated or trained as we would like. The recent decline in service I've noticed at traditional entry-level labor establishments—fast food restaurants, retail stores and the like—gives me additional source of concern about our ability to continue to recruit capable, productive individuals into the workforce. For this reason, tight labor markets remain a significant concern for me as a limit on our capacity to grow. Nevertheless, I expect that businesses will continue to hire in 1998. I see the unemployment rate this year averaging around 4 1/2 percent.

So, when you put all these supply and demand developments together, what I think you get is another good year for the economy, albeit a bit slower growth than we saw last year. My personal outlook is for both GDP growth and inflation to come in at about 2 1/2 percent for the year 1998.

Clearly, our U.S. economy has become more and more complex over time. Although there are literally hundreds of variables that interact to determine our economic outcome, at any given point in time there always seems to be one or two variables or issues that dominate. At the moment, it is the Asian crisis, and I want to say just a bit more about its impact on the U.S. overall, and on the Southeast, in particular. I have argued that the Asian impact will be limited, but let me elaborate.

On the import side, we know that some industries will be adversely affected. The apparel industry is a good example. But at the national level, the question we ask is whether American goods will be displaced in large numbers by imports. We think they won't be. Domestic demand simply remains too strong: a rising tide lifts all boats, whether they're made in Malaysia or the United States.

At the export level, demand for American goods remains very strong outside of Asia. In the short run, yes, exports to the eight Asian countries most affected by the

crisis will decline. But increasing shipments to the rest of the world will more than compensate for declining exports to Asia. Canada, Mexico and the European Union account for more than half of all U.S. exports, and each is expected to post strong gains in GDP growth this year.

As for the Southeast, the impact of the Asian crisis is mitigated by two factors. First, the Southeast is proportionately less exposed to the Asian downturn than other parts of the country, particularly the West Coast. Less than 15 percent of southeastern exports go to the eight Asian crisis nations. In the West Coast states, more than 40 percent of exports are bound for Asia; that figure exceeds 50 percent in the states of California and Washington. Just as U.S. gains from the so-called Asian miracle were concentrated on the West Coast, so are the losses now that the miracle has faltered.

The second mitigating factor for the South is the product mix we export to Asia. Much of our Southeast's Asian exports are comprised of intermediate goods, which, as the term implies, are used as inputs in the production of final goods. Intermediate goods include chemicals, plastics and forest products and account for more than one-third of southeastern exports to Japan. Because intermediate goods are used in the production of other goods, they're less dispensable than other goods, even at higher prices. Even at higher prices, however, American manufacturers of immediate goods are so efficient that their products will still be cheaper than can be obtained from other international competitors.

In short, consumer and business demand in the United States is not likely to be jolted in any devastating way by the combination of rising Asian imports and falling Asian demand. It appears the Asian storm clouds rolled into the United States in the middle of an extensive economic weatherproofing. Had it hit at any other time, we might have found considerably more water in our economic basement.

Thank you again for the invitation to share these thoughts with you and for your attention.

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