

Speeches

The 1999 Economic Outlook

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Thank you, John, and good afternoon. It's my privilege to kick off the New Year on this side of the podium once again. This is the toughest and most astute audience I face all year—I'm not kidding when I say that—but also, along with the bank's directors, one of my very best sources of economic intelligence. So I take the invitation to return as some sort of vindication—if not of me, then at least of the economy. Thank you.

1998 in review

The current economic expansion will complete its eighth year in or around April and is now the second-longest in the post-World War II era. The longest was about 106 months, from February 1961 to December 1969. Final numbers for 1998 aren't in yet, but we believe real annual gross domestic product grew 3½ percent (or slightly more) last year, to about \$8.8 trillion. GDP growth has averaged about 2.4 percent a year since 1990 (a recession year), but for a little perspective on how two- or three-point-something annual percentage gains can begin to add up, consider that real GDP in 1990 was \$5.7 trillion. That's an increase of more than 50 percent over eight years (including a recession year).

But GDP growth is only part of the economic story. Inflation as measured by the consumer price index (CPI) declined from 2.3 percent in 1997 to about 1½ percent last year, the lowest level since 1964. And the unemployment rate fell another ½ percent to about 4.5 percent, the lowest level since 1969. Taken together, that's quite a remarkable achievement.

Now if the year I've just described sounds familiar, it's because 1998 was preceded by a similarly remarkable year. The economic benchmarks established in 1997 were exceeded and extended in 1998. Last year's economic performance was never a foregone conclusion, however. In fact, but for the underlying sources of strength in the U.S. economy—sources I expect to remain throughout 1999—1998 might have been a very different year indeed.

The Asian crisis and the anatomy of a shock

The difference, of course, might have been Asia. Although the spark was struck in 1997, only one Asian economy—Thailand's—actually contracted that year (and it by less than ½ percent). Last year, of course, developing Asia's economic immolation peaked and was frankly much worse than we expected. In addition, Japan's economy, the world's second-largest, shrank by about 2½ percent, and the economy of Korea, the United States' ninth-largest trading partner, contracted more than 6½ percent. The output of Indonesia, meanwhile, home of the world's fourth-largest population, fell more than 16 percent.

Now it's true, as I noted last year, that the U.S. economy's exposure to the Asian crisis is relatively limited. Exports to the entire Asian continent—including Japan, our second-largest trading partner—are equivalent to less than 3 percent of U.S. GDP. As an economic *shock*, however, with all of its indirect effects, the Asian crisis was very serious indeed.

Economic shocks, to refresh your memory, are developments that swiftly and dramatically alter relative prices or the expectations of market participants. The most memorable shocks in our recent economic history have been negative—OPEC's oil production cuts in the 1970s and the 1990 invasion of Kuwait by Iraq, to cite two notorious examples—but sometimes they're positive, as with the oil surplus in this decade. Taken alone, shocks *can* have a relatively minor economic impact. But it's not the relative size of the shock or its individual bearing on the economy that matters alone. What matters, too, is the collective reassessment the shock triggers among consumers, businesses, investors and policymakers, and the imbalances and policy inconsistencies that this reassessment subsequently exposes.

Considered in this light, the Asian crisis—for the United States, at least—was a classic economic shock. It has been an unmitigated calamity for the afflicted countries—and certain American companies, too—but its cumulative economic impact on the United States has been small. Moreover, it has carried with it two significant mitigating factors: the lower cost of capital delivered by the financial markets' "flight to quality" and lower prices for many goods brought about by competition from cheaper imported goods. Finally, in a literal sense, the most important part of the Asian crisis—Japan—wasn't (or shouldn't have been) shocking at all. Disappointing, yes, but certainly not unexpected given its recent economic history.

But if the direct impact of the Asian crisis on the U.S. economy was marginal, its impact on market expectations most assuredly was not. That truly was shocking. On the international front, markets panicked. Capital flight, a perfectly rational reaction to previous developments in Asia, became—in my opinion—indiscriminate and out of proportion to the remaining risks in the region and elsewhere. It was as though much of Southeast Asia had become North Korea. All of this, of course, was compounded by the August 17 default of the government of Russia. U.S. exports to Russia are equivalent to just about 4/100 of 1 percent of U.S. GDP, but the impact of the default on financial market confidence was profound. All of a sudden, there seemed to be no risks worth taking—at any price—in the world's developing economies.

Financial uncertainty prevailed in the United States too. Stocks declined dramatically in late summer and early fall. Exploding demand for safety and liquidity pushed the yield on the 30-year bond—the safest and most liquid investment in the world—below 4.8 percent, to its lowest level ever. The spread between junk bonds and 10-year Treasuries, meanwhile, more than doubled between January and October. Finally, the two major surveys indicated that consumer confidence took a big hit in the late summer months. Taken together, it was as though a sort of manic depression had seized financial markets at home and abroad, with consumers, businesses and investors moving—as many commentators observed—from exuberance to pessimism, gloom and, for some, even fear.

Three sources of economic strength

And in an economy in which the expectations of consumers and businesses dictate demand, output and prices—that is to say, in a market economy, in *our* economy—a shock can change things in a hurry. The fact that the Asian shock did *not* substantially alter underlying economic conditions—the fact that the U.S. economy flourished in the face of towering uncertainty—underscores the breadth and depth of its basic sources of strength.

First, the economy remains fundamentally **balanced**. Imbalances occur when supply or demand in one or more particular industries gets inordinately ahead of the other. And while an expansion can endure for a while with some imbalances, a shock-induced retrenchment is much more likely to send a seriously imbalanced economy into recession. The 1982–90 expansion, for example, came to an end when the shock that was Iraq's invasion of Kuwait exposed lingering high-risk corporate debt, highly leveraged consumer debt and an oversupply of commercial real estate. This time last year I didn't see any serious imbalances in the economy; its resilience during the Asian shock confirmed that there weren't any lurking below radar level.

Our economy's fundamental balance is perhaps all the more remarkable considering consumer and business spending **momentum**, which I'll call the economy's second source of strength. This time last year I noted that consumer and business spending, driven by gains in employment and income growth and by increasing levels of business fixed investment, remained at very high—surprisingly high—levels. Again in 1998—and notwithstanding a serious case of Asia angst—consumers and businesses continued to propel the U.S. economy forward at a mighty clip.

Which brings me to the economy's third source of strength: its **fiscal and monetary policies**. Early last month, the Wall Street Journal observed that we now live in "a world in which the greatest economic threat of the 1970s—double-digit inflation—has been thoroughly put to rest." Well, for my colleagues and me, the *threat* of inflation never dies, even if double-digit inflation—and most of the single-digit variety too—does.

For more than two decades, fiscal and monetary policies were generally at odds. Monetary policy in the 1970s was overly expansionary and then, in the 1980s, in reaction, quite restrictive. Beginning in the late 1970s, meanwhile, fiscal policy was characterized by no-end-in-sight deficits and no generally acceptable way to begin to reduce them (let alone end them). Earlier this decade, however, monetary and fiscal policies began pulling in the same direction. Policies enacted by Congress and the Bush and Clinton administrations began to bring the deficit down, while monetary policymakers continued to pursue low inflation.

The importance of this fiscal-monetary policy mix should not be underestimated. In an inflationary environment—even one that isn't high—resources are consumed by inflation-avoidance devices such as COLAs, escalator clauses or interest rate premiums (through the so-called inflation premium). Moreover, anxiety about *future* inflation discourages investment, which diminishes the capital stock and our ability to produce in the future. And when government deficits are financed by savings, resources are diverted from the private sector where they would arguably be put to more productive use. On the other hand, in a low-inflation, low-interest rate environment, when there's little inflation to mitigate, resources proceed more directly to their most efficient uses. This helps ensure that *real* output—and thus employment—continues to grow.

And in 1998, that's exactly what happened. Last year—on the 20th anniversary of the signing of the Humphrey-Hawkins Act—the economy actually achieved, for the first time, *all* of its objectives. For years, the notion that the economy could achieve stable economic growth, full employment, and low inflation *at the same time* was widely ridiculed. We know now, of course, that these multiple objectives are not necessarily inconsistent or incompatible. But, in my view, the one goal or condition that preceded the others, that made them possible—that is the current expansion's *sine qua non*—is low inflation.

The Federal Reserve's commitment to low inflation was absolutely essential in assuring the success of last year's fed funds and discount rate cuts. Absent the Fed's anti-inflationary convictions, last year's rate cuts might well have triggered inflation expectations in the financial markets, driving up the inflation premium in interest rates and obviating the desired effects of our policy easing. Because financial markets did *not* expect inflation to increase, the injection of liquidity proceeded directly to the real economy.

Finally, while the so-called policy lag remains alive and well, the alacrity with which markets responded to last year's three fed funds target rate cuts says something about the Fed's hard-won policy credibility. Think of it as the economic version of the Nixon-goes-to-China school of policy credibility. Just as a dyed-in-the-wool anti-Communist could re-establish ties with Beijing without inciting fears of a communist capitulation, an FOMC with low-inflation convictions could provide a meaningful injection of liquidity without raising concerns of an inflationary outbreak.

So in a year that might have produced mirror-image results, the U.S. economy's three sources of strength—its balance, momentum and low inflationary policies—allowed it to set new standards for economic performance.

As for 1999

All three sources of strength remain in place as we enter 1999. As for the economy's momentum producers, I think consumer spending will continue to grow but at a much more moderate pace—we think about 3 percent in 1999, compared with almost five percent last year. Frankly, consumer spending growth could stand to slow down: last year consumer spending grew more rapidly than incomes grew. A lower rate of growth will help prevent imbalances from developing in the consumer sector.

Business spending should also moderate in 1999. Last year, business fixed investment grew an impressive 11 percent. Among other things, this level of investment underscores the limited extent to which the U.S. economy is directly exposed to the Asian crisis. After all, were Asia the whole economic ball of wax (as so many stock market commentators imply), business spending would have been negative. In 1999, we expect business fixed investment to grow about 5 percent, roughly commensurate with the slowdown in consumer spending.

After declining last year for the first time since 1985, exports should move back into positive territory as the Asian bloodletting begins to subside. The economies of Canada and Mexico, our two biggest export markets, should continue to grow in 1999, though at a more moderate pace. The rest of Latin America, meanwhile—an increasingly important group of trading partners—will remain vulnerable to capital flight as ambitious economic reform measures are implemented throughout the region. While the long-term outlook for Latin America remains very bright, I expect that economic activity in that region will slow in 1999. Across the Atlantic, the economies of the European Union should grow at a healthy clip this year, perhaps exceeding (for the first time since 1995) economic growth in the United States; exports to Europe should mitigate any further reduction in Asian exports. Despite the export turnaround, however, I expect that the trade deficit will continue to widen, almost entirely because of cheaper Asia imports.

As for inflation, I expect that the free fall we saw in energy prices last year will slow considerably in 1999. Nevertheless, slightly lower energy prices in 1999 won't be sufficient to offset the minor price increases we see in other CPI categories, as was the case with last year's big energy price declines. I think this will translate into an increase in the CPI inflation rate of about ½ percentage point over 1998. I do not, however, expect inflation to increase any further in the foreseeable future.

Taken together, I think all these things will produce a year with GDP growth close to 2½ percent, inflation around 2 percent, and unemployment just over 4½ percent. Not the exceptional years of 1997 or 1998, perhaps, but a very good showing all the same.

But... One caveat. While we believe Asia has finally bottomed out, it is by no means in a recovery. Most Asian economies will continue to contract in 1999; they'll just contract less than they did last year. As for Japan, I am optimistic that a reckoning for its banking crisis is approaching and that its recently enacted stimulus package will move it toward a recovery by 2000. If Japan doesn't move toward recovery, however, and if the Asian malaise spreads to Latin America, all bets are off. This is a remote possibility, to be sure, but a possibility all the same.

Moreover

One final concern. Last month, Securities and Exchange Commission Chairman Arthur Levitt observed that while more Americans than ever are investing, the nation nevertheless faces a "financial literacy crisis." I happen to agree with Chairman Levitt, and at the Atlanta Fed we've undertaken our own financial and economic literacy education efforts. But a related aspect of this literacy crisis—one Chairman Levitt didn't mention—is what I'll call the institutionalization of unrealistic expectations.

Over the last three years, real GDP growth has averaged over 3 percent; meanwhile, inflation and unemployment, which were already low, reached generational lows in 1997 and fell again last year. I continue to remind myself—and anyone else who will listen—that there's a reason we call this performance "exceptional." I'm concerned, however, that in these exceptional years, too many Americans are, to borrow Senator Pat Moynihan's phrase, defining average up; that economic growth that's not exceptional, that's not spectacular—that's merely good—is coming to be seen as not good enough. So let this serve as a reality check: *slower* GDP growth is not the same thing as *slow* GDP growth; slightly higher inflation is not the same thing as accelerating inflation. Consumers, businesses, investors and policymakers should not proceed as though they were. Such a delusion could have real repercussions for the U.S. economy. I suspect we'll find out over the coming year.

Conclusion

In conclusion, the momentum, balance and inflation policies that have sustained the U.S. economic expansion so far ought to ensure its continuity as we move through 1999. The new year's more moderate level of economic growth, combined with ongoing low levels of inflation, ought to ensure that the expansion continues into the next millennium. For the U.S. economy, that would be a very bright beginning indeed.

Thank you again for the opportunity to share these thoughts.

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