

A VIEW OF THE ECONOMIC OUTLOOK:

OPTIMISM AND OBSTACLES

Remarks by

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Your kind invitation to meet with the Omaha Rotary Club today was particularly welcome. The timing of this occasion--with Bob Hamilton becoming your club's president this month and the announcement last week of details of our major building project in Omaha--is pleasantly coincidental. But aside from the timing, I always appreciate such opportunities to discuss issues which concern both the Federal Reserve and thoughtful business people in Omaha and Nebraska. Accordingly, I would like to visit with you today about the current and prospective state of the nation's economy.

As president of the Federal Reserve Bank, I am often asked to discuss economic events. Frankly, I have found it very difficult in recent years to make optimistic speeches in the face of the nation's problems with inflation and, more recently, serious recession. Most of us involved in economic policymaking often feel like that football coach who took the new job at East Dakota only to find that some dreamer had signed a six-year contract to start each season against Nebraska. In Lincoln. But you have to go on and hope there's room for the wounded on the trip home.

To carry the analogy further, the U.S. economy has been among the wounded, too. It was wounded first by a generation of inflation and then battered by a period of no real economic growth over the past four years. As you know, this lengthy slowdown in business activity was brought about by those many years of inflationary excesses and by high interest rates and to some extent by public policies which began in 1979 to combat

inflation in earnest.

The most recent business recession was sharp and deep, affecting even cities like Omaha with stable diverse economies. Moreover, the unfortunate human dimensions of the business downturn were reflected in high rates of unemployment here and elsewhere. Most would agree that we have paid a very high price for the gains we have made against inflation.

Now, with the worst of the economic slowdown apparently behind us, and with growth beginning again, I think it is appropriate this afternoon to take stock, and to consider whether the optimistic business news headlines of recent weeks and months truly signify a period of sustained economic growth.

Given the importance of sustained growth to the nation, I want to discuss this issue with you today by addressing the three following questions. First, is the current business recovery for real? Second, if it is real, will it last? Finally, and most importantly, will we have the proper economic policies in place to foster continuing noninflationary growth in the years to come?

To move directly to the first question, let me say at the outset that this business upturn is, indeed, for real. Earlier this year, that conclusion was more difficult to reach. Certainly there were indications of renewed business growth in the first quarter. Housing and auto sales, in particular, were strong because of lower interest rates. There were other positive signs early in the year, but because business and consumer spending overall was very spotty, many felt that the

recovery was still fragile.

In the second quarter of the year, consumer spending and retail sales picked up strength. Auto sales continued to be healthy. Reflecting these developments, businesses began to add to their inventories, leading to growth in new factory orders. This in turn, prompted stepped-up production which contributed to growth in employment and rising personal income. Since yearend, total employment in the United States has grown by nearly 1 million persons and the unemployment rate has turned downward.

The recent government estimate of 6.6 per cent GNP growth in the second quarter, after only 2.6 per cent growth in the first quarter, confirms the strength of the recovery. In my judgement, there is now persuasive evidence that the current business recovery is broadly based and is, indeed, for real.

Shifting now from the current situation to the outlook, the question arises: can we expect this business expansion to last? Or is it just a flash in the economic frying pan on our way back into the fire?

My answer to this question is that I believe that the near-term outlook for our economy is quite good. More precisely, I believe we will see continued business expansion through 1983 and into 1984. In addition to the indicators of current strength already noted, there are other reasons for optimism. One major positive sign is a more confident public mood. For example, the University of Michigan's widely followed index of consumer sentiment recently reached its highest point in six years.

Following the good results in the battle with inflation, people again are encouraged about the future. Their spending on houses and autos and other kinds of goods and services will help provide impetus for continued business growth.

Another positive factor is that both fiscal and monetary policies are geared to encourage economic recovery. The July 1 income tax reduction, for example, will put additional spending power into the economy this summer and fall. Moreover, the rapid pace of defense spending will continue to generate production and employment as the year moves on.

All sectors of the economy, however, will not be uniformly strong. One sector likely to experience continued weakness is the international trade position. With the dollar so strong in recent quarters, the nation's exports have been weak and there appears little likelihood of a sharp turnaround soon. Other sectors which are not likely to provide much boost to the economy are business capital spending, and spending by state and local governments.

Nevertheless, though the economy is not at full strength across the board, enough vigor is evident, in my judgement, to support an optimistic economic forecast for the next year or so.

Moreover, in assessing the economy's prospects, I believe that one of the most encouraging developments is the substantial progress that has been made in restraining inflation. As you know, the 3.9 per cent rise in the CPI in 1982 was the smallest annual increase in a decade. And in the first quarter of this

year, consumer prices and producer prices actually declined. Furthermore, despite strong business growth in recent months, inflation remains relatively restrained.

These welcome trends on the price front also are having favorable effects on cost structures throughout the economy. We are seeing that slower inflation is leading to a slower rise in unit labor costs, which bodes well for future inflationary trends.

Against the background of this optimistic outlook for 1983 and early 1984, I want to turn now to the third and last question I posed--namely whether or not the nation will have the necessary economic policies in place to insure that the current favorable trends can be translated into sustainable performance over the long run.

One key ingredient for the sustainability of economic recovery into the future is Federal Reserve monetary policy. As most of you know, monetary policy has earned considerable credibility in the financial markets and among the American public. This credibility stems from the Federal Reserve's consistent adherence to a firm anti-inflationary policy for the past four years, a policy which is generally credited for much of the success to date in bringing inflation under control.

In a few weeks, Chairman Volcker will meet with Congress to discuss the Federal Reserve's objectives for the period ahead. While I cannot provide details of the Chairman's upcoming statements, I am certain that he will reaffirm our commitment to

maintain progress toward price stability while providing the money and liquidity necessary to support continued economic growth.

With regard to monetary policy, some observers have expressed concern about the rapid growth in M-1, the widely followed narrow monetary aggregate. These observers fear that continued rapid growth in money will ultimately force the Federal Reserve to be more restrictive, leading to higher interest rates which would hamper the economic recovery.

We, too, are watching the performance of M-1, but we also are aware that broader money aggregates--the M-2 and M-3 measures--are pretty much on target. Nevertheless, you may be assured that we will be paying close attention to the growth of all the aggregates--and to many other economic developments and variables--as we pursue our goal of noninflationary economic expansion.

In addition to monetary policy, fiscal policy has a major role to play in promoting sustainable growth without inflation. But fiscal policy can support sustained recovery only if the major obstacle to such progress is removed. That obstacle, in my judgement, is the massive deficit position for years to come in the Federal government's budget.

The dimensions of the prospective deficits for 1983 and 1984 and beyond are staggering and may not be fully understood by the American public. As you may know, the Office of Management and Budget now is forecasting a \$200 billion deficit this fiscal

year. Even greater deficits may occur in future years unless significant adjustments are made. A major portion of the deficit this year will be related to recession-caused shortfalls in revenue or increases in spending. But a significant part of the deficit this year will be structural in nature; it would exist even if the economy were operating at full employment. What disturbs me most is that the structural deficit is expected to grow in future years, given existing spending and revenue laws now on the books. This will happen even if the economy recovers and the recession-related part of the deficit narrows.

Not only are the prospective deficits large by absolute standards, they are growing larger relative to GNP. To illustrate, back in the Eisenhower years, the deficits--when they occurred--averaged about 1/3 of one per cent of GNP. Twenty years later, during the Carter administration, the deficit averaged about 2 per cent of GNP. Current administration projections show deficits at 6-7 per cent of GNP, or slightly less with a strong economic recovery.

But it is not simply the scale of the prospective deficits which is the issue, but rather the potentially negative impacts on business growth, the financial markets, and the public psychology.

Because budget deficits must be financed by borrowing in credit markets, massive ongoing deficits pose a serious threat to prospects for sustained economic expansion. As business expands, private sector credit demands from businesses, farmers, and home

buyers may well collide with the government's financing needs, raising again the specter of "crowding out." Moreover, as both public and private credit demand grows, the likelihood of rising interest rates increases, as well. Although credit demands appear manageable this year, rising interest rates later on might discourage the borrowing needed to finance a continuing recovery. Another very important negative factor related to financing the deficit is that potential "crowding out" problems and rising interest rates--if they occur--would raise public fears about renewed inflation. Such rising inflationary expectations would surely weaken the foundation for lasting recovery which has been laid.

I cannot overstate my concern over these budget deficits because I believe that the nation stands at a critical crossroad. If we choose the correct policies, we have the opportunity to make the current economic upturn a long-lasting period of expansion.

As we all know, however, fundamental solutions to the deficit dilemma are developing very slowly in Washington because of sincere differences about the nation's priorities. As a result, for example, some observers have suggested that the Federal Reserve could ease the deficit financing problem--and help the economy sidestep possible "crowding out"--by simply creating more money. This solution, which is tantamount to monetizing the government debt, will only add to public concern about future inflation and rising interest rates. It is quite

clear to me that excessive expansion of money is not the answer to massive federal deficits--or to any economic problem, for that matter. While excessive money growth may bring temporary short term benefits, such as lower interest rates, such action will almost always contribute to higher inflationary pressures and higher interest rates over the long run.

We in the Federal Reserve believe that the economy has come so far in the fight against inflation, and has paid such a high price to reach this point, that it would be irresponsible for the Federal Reserve to foresake such important gains in order to validate federal budget deficits.

This view does not signify Federal Reserve insensitivity to broad public needs. Rather, I mean to emphasize and reinforce the Federal Reserve's long standing commitment to a credible course of moderate growth in money and credit which will support a continuing noninflationary economic expansion.

As for making the difficult but absolutely critical decisions that will resolve the budget stalemate, I have no easy answers, though the alternatives seem clear. We can cut spending or we can increase revenues, or we can do some of both. Deciding where to cut spending or how to increase revenues is not the province of the Federal Reserve. Such decisions are political in both the partisan sense and as related to the will of all Americans. As its heart, it seems to me, the budget deficit issue is a referendum on the role of government in our society. And the sooner this issue is resolved, the clearer will be the

economic outlook.

In closing, I am encouraged about the sincerity and intensity of the public debate over the budget deficits. Given this debate, I am very hopeful that our political processes will soon produce the appropriate solution--one which will enable our economy to move forward with renewed confidence on a path of sustainable growth.