

A VIEW OF THE ECONOMIC OUTLOOK:

OPTIMISM AND OBSTACLES

Remarks by

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Your kind invitation to meet with the Topeka Rotary Club today was welcome, indeed. We at the Federal Reserve Bank of Kansas City always appreciate opportunities to discuss issues which concern both the Federal Reserve and thoughtful business people in Topeka and elsewhere. Accordingly, with 1984 just over the horizon, I would like to visit with you today about the 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 of inflation and serious recession. In fact, most of us involved in economic policymaking often feel like Christmas shoppers searching for a Cabbage Patch doll. We know what our objective is, in theory, but we find that objective is difficult to achieve in practice.

To carry that thought further, all of us would like to see an economy marked by sustainable noninflationary growth. In practice, however, the story is different. As you know, our economy was characterized by rapid inflation during the 1970's, followed by a period of no real economic growth for some four years. That 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 Topeka 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 paid a very high price for the gains made against inflation. To some extent, the harsher images of severe recession have faded because 1983 has been a banner year of renewed economic growth.

When the economy finally turned the corner about a year ago and started upward, progress was difficult to see at first. Though housing and auto sales were strong because of lower interest rates, business and consumer spending was spotty and we had to wait until spring for more impressive evidence of recovery. And we got that evidence when confident consumers began spending and retail sales grew strongly. 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 during the second quarter.

While economic growth in the third quarter was slightly slower than the rapid pace in the second quarter, capital spending by businesses and spending by state and local governments added significant strength to the expansion. For the first nine months of the year, real GNP grew at an average annual rate of nearly 7 per cent--growth fairly typical of most U.S. economic recoveries.

Now, after nearly a full year of economic expansion, I think it is appropriate this afternoon to take stock, and to consider whether the optimistic business news headlines of the last 10 months or so truly signify the onset of 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 two questions. First, what is the outlook for the economy in 1984? And second, will we have the proper economic policies in place to foster continuing noninflationary growth in the years ahead?

Moving directly to the first question, I believe the economic outlook for 1984 is very good. In addition to the indicators of economic strength we have seen in 1983, there are other reasons for optimism. One major positive sign is the continuing confident public mood. 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 is helping to provide impetus for continued business growth.

Another positive factor is that both fiscal and monetary policy are geared to encourage economic recovery. Last summer's income tax reduction, for example, has put additional spending power into the economy. Moreover, the rapid pace of defense spending continues to generate production and employment gains.

As production of consumer, defense, and capital goods rises and employment continues to grow, personal income should remain

strong. Recent data confirm these trends. Thus, the bellwether Christmas selling season probably will be as good as the retailers expect and certainly will impart a healthy economic tone to the new year. With 3.6 million new jobs in the economy since recovery began, and with the unemployment rate dropping to 8.4 per cent--the lowest rate in two years--consumer optimism should continue to fuel expansion in 1984.

All sectors of the economy, however, will not be uniformly strong in 1984. While housing and consumer spending may be less buoyant next year, business capital spending and government purchases should be strong. One sector likely to experience continued weakness is international trade. With the dollar so strong for the past year or so, the nation's exports have been weak and there appears little likelihood of a sharp turnaround soon. Thus, though the economy may not be at full strength across the board, enough vigor is evident, in my judgement, to support an optimistic forecast for 1984. To be specific, I expect real growth in the 4 to 5 per cent range in 1984, a rate about average for second years of U.S. economic expansions.

To go a step further in thinking about the outlook, I believe that one of the most encouraging developments is the substantial progress that has been made in restraining inflation. Despite strong business expansion in recent months, inflation has been relatively low, as the CPI has grown at an annual rate of about 3 per cent over the last 12 months.

This welcome trend on the price front also is having a favorable effect on cost structures throughout the economy. We are seeing that lower inflation is leading to a slower rise in unit labor costs, which bodes well for future inflationary trends. For 1984, I expect that the rate of inflation will remain moderate, though some increase would normally be expected as economic expansion proceeds.

Against the background of this basically optimistic outlook for 1984, I want to turn now to the second 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 the economic expansion 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 more than four years, a policy which is generally credited for much of the success to date in bringing inflation under control.

As you know, Chairman Volcker, in discussing the Federal Reserve's objectives, has consistently reaffirmed our commitment to maintain progress toward price stability while providing the money and liquidity necessary to support continued economic growth. I can assure you that these goals will continue to have first priority at the Federal Reserve in 1984.

Those "Fed watchers" in the audience know that monetary policymaking in 1983 has required extraordinary judgement. Needing to implement a policy geared to restrain inflation, promote economic growth, and maintain international financial stability, the Federal Reserve also was faced with unusual complications this year. Problems resulting from the introduction of new deposit accounts--MMDA's and Super Nows--and unusual behavior of money velocity, or turnover, disrupted historical relationships among economic variables.

Despite these complications, monetary policy was able to help restrain inflation and boost economic growth. Moreover, it appears that the widely watched monetary aggregates--M1, M2, and M3--all will end the year within the Federal Reserve's long run target growth ranges. Given this experience, I believe that monetary policy in 1984 will continue to be conducted in a prudent and responsible way, consistent with achieving our national economic goals.

In addition to monetary policy, fiscal policy has a major role to play in promoting sustainable growth without inflation. But fiscal policy can contribute to sustained economic expansion only if progress is made in reducing the massive deficit position for years to come in the Federal government's budget.

The dimensions of the deficit for 1983 and the prospective deficits for 1984 and beyond are staggering and their effects on the economy are now being discerned by the American public. As you may know, following a 1983 budget deficit of \$198 billion,

the Office of Management and Budget is forecasting deficits of nearly \$200 billion in future years unless significant adjustments are made. While a major portion of the deficit this year was related to recession-caused shortfalls in revenue or increases in spending, a significant part was structural in nature; it would have existed 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. And this will happen even as the economy expands further.

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 administrationn projections show deficits at 5-7 per cent of GNP.

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 in the near term, rising interest rates later on might discourage the borrowing needed to finance continuing expansion. 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 finance 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. At its heart, it seems to me, the deficit issue is a referendum on the size and role of government in our society. And the sooner this issue is resolved, the clearer will be the

economic outlook for the remainder of the decade.

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