

THE ECONOMIC OUTLOOK:
PROSPECTS AND PROBLEMS

Remarks by
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Your kind invitation to meet today with the Kansas City Financial Analysts was welcome, indeed. As you know, we at the Kansas City Fed do appreciate opportunities to discuss issues which concern both the Federal Reserve and people in the financial community.

Focusing again on economic issues is in some sense a relief after several months of heated political exchanges leading up to the national election last week. Just between you and me, I'm not sure why anyone would want to be president of the United States. It's a job with no chance for promotion...and they even make you live in company housing!

But unlike the political audiences of recent months, who looked for rhetorical fireworks, audiences of financial analysts expect central bankers to deal soberly with the more weighty economic issues of the day. In this connection, I've heard it said that central bankers are like Puritans. They have a haunting fear that someone, someplace, may be happy.

I promise to stay in character today. My message includes a view that the nation's economy is in relatively good shape now, but that there are fundamental problems that demand the attention of policymakers. How those problems are addressed will, in large measure, determine the nation's economic future.

Let's look first at the current situation. As you know, this month marks the second anniversary of the economic expansion which began in November 1982. As you also know, this expansion

has been outstanding in many respects. Spurred initially by a drop in the rate of inflation, and then urged on by the decline in short-term interest rates that began in 1982, economic growth was remarkably strong in 1983 and through the first half of this year. As it has turned out, 1983 and 1984 has been the strongest period of U.S. economic growth in nearly four decades.

All in all, the past two years of economic growth have provided compelling evidence of our economy's breadth and power. In particular, we can take pride that our economy has already created more than 7 million jobs during the expansion. Moreover, we can point to many other specific positive developments, such as capital investment--which is up 25 per cent in real terms over the period. But most of all, we are pleased that the confidence of consumers and businesses has been restored after a period of stagnation and recession.

A major reason for the restoration of confidence in the nation's economic future is, in my judgement, the absence of excessive inflationary pressures. After two years of fairly rapid economic growth, inflation remains a relatively moderate 4 per cent or so on an annual basis. As you would expect--given our commitment to anti-inflation policies--we in the Federal Reserve are gratified at the progress which has been made so far.

Though the economic news has been basically good for two years now, the recent slackening in the pace of business growth has raised questions about the longevity of this expansion. As you know, the economy slowed sharply to an annual rate of 2.7 per cent in the third quarter, down sharply from 8.6 per cent rate

posted in the first half. By and large, the summer slowdown reflected an easing in consumer spending and generally flat final sales.

This slowing of the economy has been accompanied by declines in both short- and long-term interest rates. These declines have not been offset by upward pressures on rates from continued large government borrowings. Fed funds are trading some 250-300 basis points below early-August levels, while long Treasuries are yielding some 200 basis points less than in June. Incidentally, such declines suggest to some observers that the Federal Reserve has eased aggressively. However, I would disagree, pointing out that there has been no increase in total reserves during the period in question. Moreover, there has been no decline in the discount rate and the narrow money supply, M1, has remained well within the lower part of its target range. Thus, it should be clear that market forces--not the Federal Reserve--have been the major factor in the drop in interest rates.

But despite the undeniable benefits to our economy of more moderate inflation and lower interest rates--developments that have certainly helped restore confidence in the future--a number of problems remain to be addressed before we can feel fully optimistic about the longer-term health of our economy. Many of these problems are related to adjustments required in moving from a period of rapid inflation and high inflationary expectations to a period with a more moderate inflationary outlook. As you know, many decisions made earlier in anticipation of ongoing inflation continue to plague businesses and financial institutions during

the current period of disinflation. The consequences of those earlier inflation-biased decisions often are not easily managed and, taken together, complicate the search for solutions to our economic problems.

Against that background of strong business growth and moderate inflation, I would like to consider with you briefly the outlook for the nation's economy. Before giving you my impressions of the near-term prospects for continued business growth, I want to examine the potential for the nation's long-term economic health. In so doing, I want to note some problems which, in my view, may block the path to the sustainable noninflationary growth that we seek. These problems, which include the high value of the dollar, the strains affecting our financial institutions, and the federal budget deficits, are interrelated.

One problem is the international strength of the U.S. dollar resulting from our relatively high interest rates and our relatively favorable business climate. With the dollar so high, U.S. exports have been weak as domestic producers have been priced out of world markets. Overall, the poor performance of the export sector has caused the current business expansion to be unbalanced. Our own region, in particular, has suffered because agricultural producers have lost many export sales and other sectors serving agriculture have been robbed of their potential growth. At the same time, the flood of imported goods priced in weaker currencies relative to the dollar has contributed to the serious imbalance in our trade position, while stealing sales from our domestic businesses.

To be sure, a strong dollar has brought our economy some temporary benefits. One is that the inflow of foreign capital has helped in the short run to finance both the business expansion and the federal budget deficit. Another benefit is that the availability of abundant foreign capital has kept our interest rates lower than they otherwise might have been. But these so-called benefits have certain undesirable side effects. Some observers have pointed out that the United States is rapidly becoming a net debtor nation, an unfamiliar situation, indeed, for the richest nation in the world.

When the international value of the dollar eventually declines, which it must, the consequences of that decline will present mixed blessings, at best. On the positive side, a lower dollar will certainly improve the competitive position of U.S. goods in world markets and boost our lagging export sector. However, a falling dollar could put upward pressure on domestic interest rates--as foreign capital moves elsewhere. Moreover, a declining dollar could lead to some inflationary pressures as foreign goods become more costly and as domestic businesses lose some competitive price discipline. In any case, the strength of the dollar is a problem now and a decline in its value may present other serious consequences in the future.

In addition to the strength of the dollar, a second problem that complicates the outlook for the economy is the continuing strains affecting our financial institutions. One highly visible aspect of this problem is the inability of many lesser developed countries to repay or service their huge debts on time in the

face of worldwide recession and disinflation. This situation has raised questions about the earnings and capital positions of many of the world's major banks. Fortunately, it appears that lower interest rates, restructured loan agreements, and worldwide economic growth have begun to remove some of these pressures. Nevertheless, resolution of the problem will require considerable time and its effects will add a precautionary flavor to the outlook for years to come.

Though the international debt crisis dominated many of the headlines over the last two years, financial institutions have also been beset by domestic troubles, as well. An extended period of high interest rates--caused, in my view, by the federal budget deficits--has created continuing difficulties for many business firms, particularly in agriculture and energy sectors. These problems, in turn, have been felt by financial institutions struggling to help finance the economic expansion. Financial deregulation has also contributed to the problems of financial institutions. Weakened thrift institutions and a high level of bank failures are symptoms of such problems.

A third--and the most troubling and pervasive--problem clouding the economic outlook is the current and prospective Federal budget deficits. Now, I don't plan on "preaching to the choir" today because I am sure that most of us here share the conviction that meaningful action on the budget deficits would bring lower interest rates, encourage investment, contribute to continued progress against inflation, and set the stage for a sustained period of economic expansion.

Though I don't plan to detail again the multiple perils of the deficits, I do want to emphasize again my own belief that their reduction and eventual elimination would remove a persistent thorn from the side of the nation's economic potential. Not only that, progress against the deficits would help resolve the other problems I have noted. Does anyone not believe that real deficit reductions would reduce real interest rates and diminish the inflationary biases generated by such massive deficits? Such a result surely would help relax upward pressure on the dollar and permit U.S. exports to compete more effectively in world markets. If the dollar's relative value could be reduced gradually, a series of orderly adjustments in international financial and commodity markets could take place. Furthermore, if deficit reductions ease interest rate pressures, our financial institutions could anticipate further relief from the strains I described earlier.

Thus, in the final analysis, a meaningful deficit-reduction program is a necessary step in resolving the problems clouding the long-term economic outlook. Moreover, in my judgement, such a program is essential for the ultimate economic health of the nation.

Given that background, now let me turn to a brief discussion of the economic outlook for 1985. On this count, I remain optimistic that moderate and sustainable economic growth with relatively low inflation can be achieved next year. I say this because of recent developments that appear to have set the stage for such an outcome.

For one thing, interest rates are declining. The most important reason for this development is that credit demands have weakened as the economy shifts from rapid growth to a more sustainable pace. But I believe that recent interest rate declines also reflect optimism about the course of inflation. Downward pressure on oil prices and continuing moderation in wages and commodity prices are helping to reinforce reduced inflationary expectations and to preserve real income gains. Given this positive tone, I believe that households and businesses will be encouraged to continue to lead the expansion.

These developments and their effect on the outlook are in line with economic projections made recently by the members of the Federal Open Market Committee. My colleagues and I collectively look for real GNP growth next year in the 3 per cent range, with prices rising perhaps in the 4½ to 5 per cent range. We see unemployment in the fourth quarter of 1985 averaging about 6½ to 7 per cent.

As always, a key factor in the economic outlook for 1985 is the role that monetary policy will play. As most would agree, monetary policy has earned considerable credibility in the financial markets and among the American public because of our consistent adherence to a firm anti-inflationary policy. This policy is generally credited for much of the success to date in bringing inflation under control. Thus, it will not surprise you much when I say that, for 1985, the Federal Reserve remains committed to providing money and credit to the economy at a pace which will provide for a sustainable business expansion while, at the same time, maintaining progress toward price stability. I

should point out that the tentative growth rate ranges for the monetary aggregates previously announced reaffirm our stated intention to reduce, over time, the growth of money and credit.

In contemplating prospective developments in money and credit, we in the Federal Reserve are monitoring the situation closely. If we see signs of further economic weakness and continued slowing in the demand for money--as reflected by recent trends in money growth--we would expect further declines in interest rates. What the Federal Reserve seeks, of course, is for interest rates to come down and stay down so that greater investment and continued economic expansion will be encouraged. However, given the Federal Reserve's commitment to a policy of moderate growth in money and credit, and given no resolution of the deficit issue, a rapidly strengthening economy would undoubtedly reverse the course of interest rates.

In summary, the economy has grown steadily over the past two years, and it should continue to expand through 1985. The pace of expansion next year may be somewhat more moderate than the earlier rapid growth, but that is to be expected in a maturing expansion. Over the longer term, however, the ultimate health of the economy depends, in my view, on meaningful reductions in the huge Federal budget deficits. Such reductions would help importantly to bring about orderly domestic and international adjustments to the new environment of disinflation. I am convinced that if policymakers will address this issue promptly, an extended period of noninflationary growth lies just over the horizon.