

THE ECONOMIC OUTLOOK:  
PROSPECTS AND PROBLEMS

Remarks by  
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as a guest of the Central Missouri State University  
Economic Finance Club.

Thank you for your kind invitation to meet with you in Warrensburg this evening. We at the Federal Reserve Bank of Kansas City always appreciate opportunities to discuss issues of interest to economics and finance students of all ages.

As a native Missourian, I particularly enjoy the chance to meet with groups in my home state. The special qualities of we Missourians were immortalized in Congressman Vandiver's famous quote in 1899. He said "I come from a state that raises corn and cotton and cockleburs and Democrats, and frothy eloquence neither convinces nor satisfies me. I'm from Missouri. You have got to show me."

As a Missourian, my style is short on "frothy eloquence" as the Congressman put it. That's good, because audiences expect central bankers to deal soberly with the weighty economic issues of our time. 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 this evening. 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 part, determine the nation's economic future.

Let's look first at the current situation. As you know, the economic expansion which began in November 1982 has continued for nearly two and a half years. 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 1984.

Even though the pace of economic growth slowed somewhat beginning in the third quarter last year--a development to be expected as the expansion matured--this particular period of U.S. business growth has been the strongest since the Korean War.

Economic expansion over this period has been aided considerably by relatively favorable levels of interest rates. Though both nominal and real interest rates are still high by historic standards, consumers and businesses nonetheless have been encouraged to borrow to expand their purchases of goods and services. Strong credit demand caused short-term interest rates to trend upwards through much of 1983 and 1984, but these rates dropped sharply last fall when business growth slowed. Reacting to these declines and, to an extent, facilitating them, the Federal Reserve reduced the discount rate to 8 per cent in December, the lowest level since 1978.

All in all, the past two years or so of economic growth have provided compelling evidence of our economy's breadth and power. In particular, we can take pride that more than 7 million jobs have already been created during the expansion. And we can point to many other positive developments, such as capital investment--which is up more than 30 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 dismal period of economic stagnation and recession. That period which preceded

the current expansion included the most devastating recession since the depression of the 1930's. So the renewed public confidence is a <sup>very</sup> hard-won victory.

A major reason for the restoration of confidence in the nation's economic future is, in my judgement, the absence of excessive inflationary pressures. Now, even after more than 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 the Federal Reserve's commitment to anti-inflation policies--we are gratified at the progress made so far.

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 we seek. These problems, which include the nation's international trade deficit, 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 situation. 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. Other sectors serving agriculture have been robbed of potential growth. At the same time, the flood of imported goods priced in weaker currencies 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 benefit 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 side effects. Some

*undesirable*

observers have pointed out that the United States is rapidly becoming a 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 would 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. Whether or not the recent drop in the dollar signals the beginning of the adjustment--or was merely a temporary reaction to the Ohio savings bank problems--it is too early to tell.

In addition to the trade deficit and strength of the dollar, a second problem that complicates the outlook of 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 on time their huge debts 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 ease some of the pressure. 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 or so, financial institutions have 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. 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 bank failures--79 last year and 20 so far in 1985--are symptoms of these problems. So, too, are the well-publicized troubles of Continental Illinois and, to some extent, the Ohio savings banks last month.

A third--and the most troubling and pervasive--problem clouding the long-term economic outlook is the current and prospective federal budget deficits. I don't plan on "preaching to the choir" this evening because I am sure that most of us here share the conviction that continuing massive budget deficits present a number of potential hazards to our economic progress.

Many of us believe that the government's borrowing to finance the deficits will ultimately collide with the private sector's need for credit to fund continued growth. With both public and

private credit demand growing, the likelihood of rising interest rates increases, as well. Rising interest rates, in turn, could raise public fears about renewed inflation. High inflationary expectations would surely weaken the foundation of growth with lower inflation which has been laid.

I do want to emphasize my belief that reducing--and eventually eliminating--budget deficits 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 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 an optimist that moderate and sustainable economic growth with

relatively low inflation can be achieved this year. I say this because of recent developments that appear to have set the stage for such an outcome.

For one thing, as I noted earlier, short-term interest rates came down sharply over the last half of 1984. Though some rates nudged up slightly during the recent quarter, the general level remains well below last summer's peaks, primarily because credit demands lessened as the economy shifted from rapid growth to a more sustainable pace. But I believe that these lower levels of interest rates 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. Though early 1985 data on the economy are showing some mixed signals, continuing strength is evident in spending for construction and other capital items, in factory orders, and in overall consumer spending, including sales of new homes and automobiles.

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 this year in the 4 per cent range, with prices rising perhaps 3 1/2 to 4 per cent. We see unemployment in the fourth quarter of 1985 averaging about 6 1/2 to 7 percent.

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 the Federal Reserve's consistent adherence to a firm anti-inflationary policy. This policy is generally credited for much of the success to date in bringing inflation <sup>to lower levels</sup> ~~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 support 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 announced in February again 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 watching the situation closely. With continued moderate economic growth and typical demand for money and credit, we would expect interest rates to remain relatively stable over the upcoming period. What the Federal Reserve seeks over the long run, of course, is for interest rates to come down and stay down so that greater investment and continued growth will be encouraged. In the short run, 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 return to very rapid economic growth would undoubtedly put upward pressure on interest rates.

In summary, the economy has grown steadily over the past two and a half years, and it should continue to expand through 1985. The pace of expansion this year may be somewhat more moderate than the earlier rapid growth, but that is to be expected in a maturing expansion. If my assessment is correct, those of you about to enter the job market should find ample opportunities to put your skills and energies to work. Over the longer term, however, growing job opportunities and the ultimate health of the economy depend 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, we can expect continued good progress for the nation's economy.