

THE U.S. ECONOMY:
CURRENT CONDITIONS AND FUTURE PROSPECTS

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I appreciate this opportunity today to share with you my views on the outlook for the U.S. economy. My overall message is one of cautious optimism. I believe that by the end of this year we will be well into recovery. I am, however, somewhat less sanguine about the longer term outlook for the economy, unless policies are focused firmly toward sustainable economic growth. There is much discussion about what policies we need for the future and it is well worth the effort to draw attention to the relevant issues. Before discussing longer term issues, however, let me first turn to the near-term outlook.

The Economy in 1992

Our economy has admittedly been in difficulty for the past several quarters. Total output has grown little. Job losses have mounted, spurred in part by a retreat in the auto and commercial real estate industries from the boom years of the 1980s. Moreover, consumer confidence measures clearly show that the American people are pessimistic about an economic recovery this year.

Despite this pessimism, however, I am reasonably confident that a recovery will become apparent within the next few weeks and months. If so, confidence should return to households and businesses and contribute to a faster pace of economic growth over the second half of the year. Some private forecasters expect a GDP growth rate of less than 2.0 percent for the year. This cautious projection may be a reaction to expectations last year of better performance for the economy. My own view is that economic growth is likely to be slightly above this 2.0 percent rate.

There are a number of reasons for this optimism. Among the most important is the general decline in interest rates. The federal funds rate has come down 1 1/2 percentage points just since last summer. At 4 percent, the funds rate is at the lowest level since 1972. Other short-term interest rates

are also at or near their lowest levels in years. More importantly, long-term rates have also declined substantially. Despite some uptick in recent weeks, 30-year Treasury bonds now yield below 8 percent, down about three-quarters of a percentage point since last summer.

This decline in interest rates will stimulate activity throughout the economy. We have already seen a pickup in the housing industry in response to lower mortgage rates. Recent data suggest that homebuilding is likely to continue to improve as families take advantage of the most affordable home finance terms in several years. Increased sales of new homes will boost sales of home furnishings and appliances, contributing to higher demand for consumer durables.

Automobile sales also will benefit from lower interest rates. Don't get me wrong—I am certainly aware that 1992 will not be a boom year for the Big Three automakers. But starting from the very low base of 1991, this year should see some improvement in production of American cars. Despite the recent plant closings announced by General Motors, I would expect employment in the automobile and related industries to stabilize in the months ahead.

Beyond these industries, U.S. businesses more generally will benefit from a low interest rate environment. The cost of new equity capital is declining. The ability and incentive to raise capital are thus far greater now than they have been in recent memory. Between January and November 1990, for example, equity capital raised in the markets was a mere \$24 billion; for the same period in 1991 this figure was \$64 billion, almost three times the earlier level. The effect of such equity additions is to strengthen corporate balance sheets, ease funding strains, and facilitate expansion. I thus expect some moderate increase in business spending on new plant and equipment.

The extent of the increase in business investment will of course depend on any tax package that might be passed. If current proposals for accelerated depreciation or investment tax credit

become law, investment spending could be quite robust later in the year. Proposals to provide tax relief to middle-class households would boost consumption spending.

American products are quite competitive in today's world market and I therefore expect further expansion of U.S. exports this year. However, this expansion will no doubt be impeded somewhat by expected slow growth in other countries. Canada already may have slipped back into recession, Germany has experienced declining output in adjusting to reunification, and even Japan is expected to show a pronounced slowdown in growth needed to correct previous asset-price inflation. Thus, while exports will show some growth, the rate will unlikely match that of last year.

Government spending will be a drag on U.S. growth this year, despite this being an election year. The budget agreement is still a restraint on federal spending, and the collapse of the former Soviet Union has allowed for further reductions in military outlays. Moreover, many state and local governments are in the midst of a fiscal tightening. They certainly will not be expanding programs until they can stanch the flow of red ink.

With a moderate recovery, the unemployment rate may remain near 7 percent for much of the year. That is the downside of having moderate rather than robust growth.

Accompanying the recovery will be continued progress against inflation. The underlying inflation rate has declined to less than 4 percent and is moving us further toward price stability.

This goal of price stability is mistakenly interpreted by some as being an end in itself. On the contrary, stable prices are important because they provide an environment for more robust economic growth in the long run.

With inflation like that experienced during the late 1970s and early 1980s, it "pays" to be clever, to speculate, to be influenced by nominal rather than real values. But in an environment of

stable prices, this "fool's gold" dissipates--allowing market participants to focus on productive ventures. Stable prices also give renewed meaning to savings. People who save are rewarded with consistent real returns for their effort.

I would observe, for example, that between 1948 and 1967 average annual inflation was just under 2 percent while average annual economic growth was nearly 4 percent. However, between 1970 and 1990 these figures were reversed, with 6.2 percent average inflation but only 2.6 percent average growth. While these periods were in many ways different, the fact is both strong growth and price stability can be achieved simultaneously.

In summary, I expect a strong stimulus to the economy coming from lower interest rates. I expect demand for housing, durable goods, and automobiles to strengthen, and inflation to decline further. Also, business fixed investment should increase, as corporate balance sheets improve and the recovery gets underway. However, the recovery will be slowed to some degree by reductions in government spending and a slowdown in the rate of export growth.

Prospective Policies

Generally, then, I am optimistic about the direction and degree of economic recovery in the near term. However, as I mentioned, there are a number of policy issues that need attention if we are to sustain this recovery well into the future.

To put the discussion into some perspective, witness the effect of even small changes in economic growth rates on our standard of living. If economic policies could be geared toward long-run prosperity, the potential growth rate of the U.S. economy might be increased an average of one-half percentage point. This may not sound like much of a payoff, but maintaining this small increase

over the next 50 years would, in the end, raise average living standards by 25 percent. Think of how much more progress could be made against poverty, inadequate health care, and educational needs if GDP were 25 percent higher.

The policy areas needing attention are not new. They require the application of some basic economics and common sense.

The foremost area requiring attention is the federal budget deficit. After growing at a double-digit rate for most of the last decade, federal debt now stands at about \$4 trillion. This appetite of government for money must necessarily crowd out private borrowers from credit markets. If American industry is to remain competitive in world markets, private businesses need greater access to affordable capital. It logically follows, then, that budget deficits need to be reduced systematically.

Some fear that eliminating deficits would inevitably require onerous tax hikes. But higher taxes are not the only way to achieve this end. There is room to reduce federal spending before taking up the question of higher taxes. The collapse of the Soviet Empire presents obvious opportunities to cut expenditures. However, we should not allow this to make us lax in addressing nondefense areas. Entitlement programs, which account for half of government spending, should be scrutinized to determine which might be reduced and which might be desirable but are unaffordable.

Getting our federal spending and deficits addressed would allow us to refocus on investing in the nation's productive capacity. More emphasis could be given to improvements in the infrastructure, and much-needed capital might be redirected toward private investment in productive capacity. Indeed, private investment in the United States has not been keeping pace with the rest of the world. For example, business investment in the United States over the last decade has averaged

less than 12 percent of output, well below comparable figures for Germany (14.4 percent) and Japan (16.4 percent). We must therefore begin to direct capital spending toward investment if America is to remain a competitive, world-class economy in the twenty-first century.

In speaking of the need to increase investments, a simple principle must be remembered also; that is, for investment to increase, savings (domestic or foreign) must increase also. In the United States, however, like investment the savings rate has been consistently low. For example, over the past decade, personal U.S. savings as a percent of GDP was about 4 1/2 percent, while in Japan it was nearly 11 percent and in Germany it was above 8 percent. It is apparent that the U.S. savings rate lags the rest of the world and is just simply too low.

To address these areas, changes in the tax code certainly would be helpful. Eliminating the double taxation of dividends, for example, and reducing the capital gains tax would give American industry tax treatment more similar to that in other industrial economies. Moreover, the investment tax credit now being considered would not only increase investment in the long run but would also help "jump start" short-run economic recovery. Other tax reforms that would be helpful include reducing the tax on interest income, thereby encouraging Americans to raise their too low rate of saving.

A country's wealth, its ability to create jobs, rests importantly on its manufacturing and industrial base. Thus, the United States must place renewed emphasis on assuring that its investment and savings rate is stimulated and revitalized.

Finally, there was a time when you could talk about U.S. growth without too much concern for international trade. But those days are a distant memory, imports and exports are now above 10 percent of GDP. Most notable, however, is that today we are consistently running sizable trade

deficits.

These deficits are bothersome and many groups are calling for trade restriction as a means to saving jobs within the United States. Such policies, however, I believe are counterproductive. Trade barriers--whether here, in Japan, in Europe, or elsewhere--benefit primarily special interests, not the general public or domestic workers. Protectionist legislation did not work in the 1930s and it will not work in the 1990s. Instead, the United States should reject protectionism and continue to lead the world toward free trade, which has systematically raised world living standards since World War II. Existing trade barriers should be systematically eliminated. Pursuing open and free trade and encouraging investment in our domestic economy will best ensure a continued increase in living standards for all.

Conclusion

In summary, the U.S. economy is set to recover. Interest rates are at their lowest levels in decades, equity issuances are at recent historical highs, and corporate balance sheets are strengthening. We in the United States should take advantage of this opportunity to begin to focus our attention on the long-run needs of this economy and our desire to ensure sustained economic growth. Our efforts must be directed toward investment and savings; and these areas can only be properly addressed if we first examine and prioritize government spending. This will not be easy, but it is necessary.