

THE ECONOMIC OUTLOOK AND MONETARY POLICY

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### I. Introduction

A. Comments will focus on two principal topics:

1. Near-term outlook for the economy and monetary policy, and

2. Longer term challenges to policymakers posed by the rapidly changing economic environment.

o Among these major changes are the restructuring of the U.S. financial system and the growing internationalization of the U.S. economy.

B. Message: While the outlook for the economy is fairly bright in the near term, the rapidly changing economic environment poses a major challenge to policymakers as we seek to achieve conditions that will foster maximum sustainable economic growth.

### II. Near-Term Outlook

A. The economy today looks much better than a year ago.

1. In January 1992, the economic recovery was struggling against very strong currents.

o These currents included: high debt burdens of consumers and corporations; commercial real estate weakness and attendant problems for lending institutions; slow economic growth abroad--which hurt U.S. exports; and the large U.S. government deficit--which absorbed a large portion of private savings.

2.To help overcome these currents, the Fed eased monetary policy throughout 1993.

oWe lowered reserve requirements to encourage more bank lending, and lowered our discount rate and short-term money rates to the lowest levels since the early 1960s.

3.Reflecting in part the effect of these actions, the economy began to improve during the year but especially so in the latter half of 1992, with consumer spending being especially strong at yearend.

4.Overall, last year the economy grew 2.9 percent (QIV/QIV).

oImportant also, inflation continued to subside (CPI inflation QIV/QIV was at 3.1 percent).

oEmployment gains, however, were more modest, and the unemployment rate declined only gradually, reflecting the structural adjustments still underway in the economy. (The unemployment rate ended last year at 7.3 percent, and this January it fell to 7.1 percent.)

B.On balance, the economy enters 1993 on a solid footing.

1.The strengthening of the balance sheet for consumer and business has improved prospects for these sectors.

oRecent gains in productivity and corporate profitability underscore these improvements.

2. Financial institutions have improved their balance sheets as well, and are in a better position to lend.

- o Recent gains in bank stock prices underscore this sector's improvement.

3. As a result of these improvements--which reflect past easing of monetary policy--I look for economic growth to increase gradually through 1993, averaging about 3.0 percent for the year as a whole.

- o Inherent in this outlook is that the current low level of interest rates will continue to stimulate the housing sector, consumer spending on durables, and business spending on plant and equipment.

4. Two sectors could be a drag on the economy.

- o Net exports will probably weaken, as slow growth abroad hurts U.S. exports and stronger growth at home stimulates U.S. imports.

- o Government spending, especially on defense, is likely to decline further--continuing the structural readjustment problems in this sector that we saw in 1992.

- o President Clinton's fiscal stimulus package--its nature, size, and timing--ranks as a major uncertainty. And the deficit even if solidly addressed will continue to drain savings from the private sector.

5. Reflecting all these factors, I look for continued moderate economic growth in 1993, some further improvement in job growth, and further downward

movement in inflation.

6. Monetary policy in 1993 will support further economic growth.

a. Chairman Greenspan's report to Congress on monetary policy objectives stresses our desire to foster financial conditions conducive to maximum sustainable economic growth over time.

b. It also stresses the belief that a noninflationary environment is a precondition to achieving such a goal.

c. Controlling inflation is important because inflation is costly; it discourages savings and investment by creating uncertainty about future prices, it distorts the decisionmaking process with the market, it causes inefficiencies; and thereby reduces overall economic growth.

d. Further progress toward price stability as a necessary ingredient to long-run growth, therefore, remains one of the Fed's primary goals.

3. Transition: In addition to these considerations affecting the outlook, the critical question for policymakers in 1993 and beyond is how to respond to the many fundamental changes now occurring in the economic environment.

### III. Longer Term Outlook and Challenges

A. One major change now occurring is the diminishing role of banks in the financial

system--i.e., the banking sector is shrinking.

1. In 1970, banks provided nonfinancial companies with about 85 percent of their short-term credit. Today, banks have just 60 percent of that market.

Also, bank deposits as a share of household financial assets are about half of what they were 15 years ago (from about 40 to 20 percent).

2. The diminished role reflects:

- The rise of deposit substitutes, e.g., stock and bond mutual funds,
- The scaling back of traditional loan-making activities (into securities), and
- Higher capital requirements.

3. One issue that falls out from this concerns whether sufficient credit will be available to support a growing economy.

- Large firms have alternative sources of credit--stocks, commercial paper, etc.; but small and medium-sized firms may not since they are dependent on bank lending.

- The credit crunch of 1990-92 is thought to be a direct result of these factors and remains an important topic in policy circles.

4. Another policy issue concerns the need to monitor these changing market structures and new market instruments to assure safety of the system and the adequacy of credit.

B. Another major change is the growing internationalization of the U.S. economy.

1. The U.S. economy is more open now than ever before. As a result, the United States is more vulnerable to events overseas.

- o International trade represents a significant share of GDP (exports plus imports are 24 percent of GDP, compared with 16 percent ten years ago). The United States is more dependent on trade.

- o Capital flows have increased enormously, spurred by deregulation, technical advances in communication, and growth of market instruments here and abroad. Large capital flows can have a major effect on interest rates and exchange rates.

2. A recent example is the major turmoil late last year in European exchange markets.

- o High interest rates in Germany led to major disparities in economic conditions in other European countries, huge speculative pressures against some fixed-rate currencies, and eventually to major changes in interest rates and exchange rates in those countries.

- o The U.S. economy is being impacted because, with the turmoil and difficulties being experienced by many of our principal trading partners, our exports likely will be weaker this year, and our trade deficit will be larger.

3. With our financial markets and economy more interdependent than ever, this country is faced with policy challenges in the international arena that are as

great as any in recent history.

4. The advent of NAFTA and a single European Community will only accelerate the importance of these policy challenges.

C. Restructuring of U.S. businesses is the third major change in the economic environment.

1. The causes of restructuring include:

- Increased domestic and international competition,
- Progress toward price stability, and
- Technological changes.

2. Results: Businesses are controlling costs, especially labor costs, to achieve profits, rather than increasing prices.

- Job growth has slowed markedly.

3. A policy implication is that if job growth is to be enhanced, labor productivity must be increased over the long run.

- To do so, we need a skilled labor force and the relative cost of labor and capital must decline. But with accelerating health care costs and other impediments to productivity, gains in productivity will be difficult to achieve.

4. Monetary policy's contribution to the need to improve productivity and lower cost is best achieved by further reducing the inflationary premium in interest rates, thereby lowering the long-term cost of capital.

IV. Conclusion

A. The economic outlook is fairly bright for 1993, in large measure because consumers and businesses are now in a healthier financial situation than before.

B. In 1993 and beyond, policymakers will need to be sensitive to the major, ongoing changes in our economic environment--including the changing role of banks, the growing internationalization of our economy and financial markets, and the need to foster investment, productivity, and economic growth.

C. As always, the financial markets will be the "keeper of the scorecard" on our actions and on the actions of the new Administration and Congress.