

# THE U.S. ECONOMY: A LOOK AHEAD

Comments By

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I. Introduction

1. Today, I would like to offer my perspective on the current state of the U.S. economy and provide some thoughts on the longer term economic outlook.

2. In the near term, I am confident that we are likely to see a continuation of relatively strong economic growth in the United States. I am also optimistic about the long-term prospects for the U.S. economy.

3. Our success in achieving economic progress over a longer time horizon, however, will depend greatly on our ability to take policy actions that ensure we reach and maintain our full economic potential.

II. An assessment of the current state of the economy

1. Currently, the economy is in good condition.

a. Real economic growth increased 4.1 percent last year, and posted a gain of 5.1 percent in the fourth quarter.

b. This strong growth led to very impressive employment gains. The economy created over 3 million new jobs in 1994, and these job gains led to a significant drop in the unemployment rate--to the lowest level in four years.

c. The strength in the U.S. economy last year was broad based.

o Personal consumption spending, business fixed investment, and business inventory spending were all strong.

- o Particularly impressive was the significant increase in U.S. exports. For the year as a whole, export growth was twice the pace of the preceding year.
  
- d. And, inflation was well-behaved. Despite some indications of tightening labor markets and increased materials prices, inflation remained under control. The consumer price index, for example, rose only 2.6 percent.
  
- 4. This year, I anticipate continued solid growth, but at a more moderate and sustainable pace. I'm looking for real economic growth to be in the vicinity of 2 1/2 percent.

  - a. The principal reason for expecting a reduced pace of U.S. economic activity this year is the effect of last year's interest rate increases on housing and other interest-sensitive sectors of the economy.
  
  - b. With mortgage rates up, we have begun to see a slackening in residential construction activity.
  
  - c. We also are seeing signs of some moderation in consumer spending, particularly on big-ticket items.
  
  - d. In addition, inventory investment is unlikely to contribute significantly to growth, as it did last year.

  
- 5. Nonetheless, the overall outlook for 1995 remains very positive, and I would like to highlight a couple of factors that are likely to support continued solid growth this year.

- a. The first factor is the likelihood of continued strength in U.S. exports.
- o As I indicated earlier, exports contributed importantly to the stronger-than-expected performance of the U.S. economy during 1994.
  
  - o While our sales to Mexico will be down this year as a result of the recent problems in the Mexican economy, sales to most of our other major trading partners will likely be up.
  
  - o In particular, a pickup in the Japanese and European economies will boost the demand for our goods.
  
  - o The recent decline in the dollar will also contribute to increased exports.
- b. The second positive factor is continued growth in business fixed investment. While these expenditures are not likely to be as vigorous as last year, manufacturing capacity utilization rates are very high, which should lead to a strong demand for new structures, machinery, and computers.
- c. A third positive factor for the U.S. economy in 1995 is the continued strength in U.S. bank lending.
- o During the early stages of this expansion, credit flows were very weak. Consumers and businesses reduced their demand for credit to lower their debt burdens and repair their balance sheets. At the same time, banks were reluctant to extend new credit. Indeed, bank business loans declined for three consecutive years --in 1991, 1992, and 1993; a period that was referred to, not so affectionately, as “the credit crunch.”

- o Recently, bank loan demand has increased considerably. And, banks have shown an increased willingness to lend, as evidenced by an easing of terms and standards on new loans. As a result, both business and consumer lending have rebounded sharply.

- o I believe these improved credit flows provide additional support to the view that there will be considerable underlying strength in the economy in the period ahead.

### III. Keys to long-term growth

1. With this favorable near-term economic outlook, we now have an opportunity to focus our attention on some important long-run issues.

2. Over a longer time horizon, the ability of the U.S. economy to continue to provide new jobs and raise living standards will depend on our ability to promote sustainable economic growth. Today, I would like to highlight four keys to our economy's long-run performance.

3. The first key is a continuing commitment to open international markets for goods and services.

- a. In a world economy that is increasingly interdependent, international trade is a vitally important factor stimulating growth. While trade liberalization may have certain short-run costs, as some industries must adapt to increased competition, these costs are outweighed in the long run by the benefits of growing export markets and lower prices for consumers.

- b. As the world's largest economy and single-largest exporter, it is important that the United

States take the lead in reducing trade barriers worldwide.

- o Last year's passage by Congress of the GATT agreement was an important milestone on the road to lower trade barriers and greater world economic growth.

- o And, while the recent problems in Mexico haven't allowed the full potential of NAFTA to be realized, the GATT and NAFTA agreements in tandem will certainly enable the U.S. economy to derive long-run benefits from an expansion in world markets that stimulates exports and new job creation.

- o For that reason, I am in favor of the multinational efforts taken recently to help stabilize the financial environment in Mexico and some other Latin American countries. Also encouraging are the stringent economic policy actions adopted by these countries.

4. A second key to long-run growth is the provision of a positive climate for investment and savings.

- a. Our long-run economic potential depends critically upon our ability to provide incentives for businesses to make productive investment decisions and for households and businesses to generate the savings necessary to finance these investments.
- b. Unfortunately, our economy has fallen behind other industrialized countries in generating savings and investment. For example, our personal savings rate, which runs between 4 and 5 percent of income, is less than half that of Japan and Germany, and private investment spending has lagged as well.
- c. Part of the investment shortfall can be attributed to the large federal government budget

deficits in the United States that have absorbed financial resources from the private sector.

- o While we have made some progress in reducing the budget deficit, the long-term outlook for deficit reduction poses a serious problem.
  
  - o For example, there is increasing concern about the projected huge growth in government spending on entitlement programs, such as pensions, social security, and Medicare. Projected out to the year 2030, it is estimated that entitlement spending alone will consume all tax revenue collected by the federal government, leaving no funds to pay for other programs or even to pay interest on the national debt. Controlling these expenditures will be extremely difficult and presents some very difficult choices, including reducing promised benefits, raising taxes, and perhaps privatizing these programs as is being done in other countries facing a similar dilemma.
- d. As you know, there have been a number of proposals circulating in Washington designed to change tax laws to stimulate investment and savings. These include capital gains tax reform and switching from an income tax to a consumption or value-added tax to encourage savings.
- o Without commenting on the relative merits of these proposals, I would stress that for any proposed tax changes to have a positive impact on investment and savings incentives they must be fiscally responsible. If such actions result in further increases in the size of the deficit, the long-run effects on saving and investment will be negative, and long-term potential growth will be harmed.
  
  - o Therefore, it is vitally important to continue to emphasize a reduction in government spending as a key ingredient to reducing the budget deficit.

5. A third key to long-run performance is maintaining a strong and vibrant financial system.
- a. Our future growth prospects will be enhanced by a stable financial system that helps channel savings to their most productive uses.
  - b. In this regard, one of the most important developments in the past few years is the return to health of our commercial banking industry. Improved profitability and higher capitalization have allowed banks to put problem loans behind them and have positioned them to meet the credit needs of an expanding economy.
  - c. Looking ahead, there are two important changes in the financial environment that may affect financial stability.
    - o One change is the growing interdependence of world financial markets, which increases the likelihood that economic or financial problems in one country may spread to other countries.
    - o The second change is the growing use of new types of financial instruments such as derivatives. Recently, we have seen several instances where financial institutions, corporations, and municipalities have experienced large losses from these instruments. Maintaining financial stability in this changing environment will require greater understanding of the risks involved by regulators both here and abroad, and a greater degree of international cooperation among regulators.
6. The fourth and final key to future prosperity is the one that is central to the mission

of the Federal Reserve: price stability.

- a. An environment of stable prices contributes to higher potential economic growth by promoting productive investment and savings decisions. From our experience in the 1970s and 1980s, we have seen how quickly an increase in inflationary expectations can be built into market interest rates and distort investment and savings decisions.
- b. Moreover, because inflationary expectations are so difficult and painful to eradicate once they become entrenched in the economy, it is vitally important that monetary policy respond quickly to signs of inflationary pressures.
- c. While the near-term outlook for inflation remains favorable, it is important that we do not become complacent.
  - o For several months we have been seeing increases in the prices of raw materials and in industrial goods. And, it now appears that some of these increases are being passed on to the consumer level.
  - o Moreover, measures such as the unemployment rate and the manufacturing capacity utilization rate suggest the economy is now operating past the point of full capacity, which increases the prospects of a pickup in inflation in the months ahead.
- d. More than likely, inflation will move up to the 3 1/4 percent range this year. As long as inflation is capped at this level, it might be considered an acceptable outcome for this stage of the business cycle. Anything higher, however, I would view as unacceptable; and I would prefer to see inflation trend downward from this point forward.

- e. It is important to remember that inflation is ultimately a monetary phenomenon. That is, a sustained increase in inflation cannot occur without monetary accommodation.
  - o Accordingly, the Federal Reserve's actions to tighten monetary policy this past year have looked beyond the immediate time period. They have been designed to achieve further progress against inflation over time and, thereby, help ensure that the economy will operate at a sustainable pace in the period ahead.

#### IV. Conclusion

- 1. In conclusion, I want to emphasize my optimistic assessment about our economy's future.
  - a. This year, the economy should continue to grow, albeit at a more moderate and sustainable pace than last year. Moreover, the long-run outlook for the economy is also very positive.
- 2. As I have indicated, however, achieving our economy's full potential in the coming years should not be taken for granted.
  - a. It will depend in part on how successful we are in promoting open international markets, encouraging savings and investment, and maintaining a healthy financial system.
  - b. And, as history and recent developments most assuredly tell us, achieving sustainable economic growth in the future will depend crucially on our ability to foster and maintain price stability over time.