FEDERAL RESERVE BANK
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OFFICE OF
THE PRESIDENT

THE ECONOMIC OUTLOOK AND CHALLENGES FOR MONETARY POLICY

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Economic growth in the United States has slowed recently, raising concern in many quarters that the current economic expansion is coming to an end. After growing at an acceptable, but unspectacular, 3 percent average annual rate during 1985, growth in the economy's output dropped to just over two percent in the first half of this year.

Over the past year and one half, the U.S. civilian unemployment rate has been stuck between 6 3/4 and 7 1/4 percent, higher than the 6 to 6 1/2 percent rate that appears to represent "full" employment in the U.S. economy. Moreover, capacity utilization in manufacturing actually has declined rather substantially.

Unemployment in Washington has been somewhat higher than in the U.S. as a whole, averaging about 8 percent over the past year and one-half. However, the unemployment situation here has improved substantially, having fallen from a 9 percent rate in January 1985 to 7 3/4 percent last July. Moreover, total employment grew at a very strong 6 1/2 percent annual rate from January to July of this year.

The outlook for the U.S. Economy is subject to a number of major uncertainties, perhaps more than usual. Nevertheless, I believe that a pick-up in the economy is in the offing. Thus by the end of next year, the U.S. economy will have made significant progress towards a fuller employment of both labor and capital. The Washington economy also should show good growth next year, although it probably will not increase quite as robustly as it did in 1986.

This national outlook of improving economic activity is encouraging. But it should not cause us to lose sight of the need to continue making progress towards the longer run goal of stable prices. With the economy poised to accelerate, the risks of higher inflation further down the road are increased. Against this background, the goal of ultimately achieving sustainable economic growth in a non-inflationary environment is a special challenge.

The Fundamentals

I expect the real economy to register a growth rate averaging about 3 percent over the remainder of this year and next year. This optimistic outlook is based on favorable movements in two fundamental factors that influence real growth. First, the international value of the dollar has dropped about 35 percent since February of last year. This drop enables U.S. exporters to compete more effectively in markets abroad, while foreign producers find it more difficult to compete in our markets. Thus, our trade deficit soon should begin to improve, and should contribute significantly to economic growth next year. For Washington, the weaker dollar is helping to boost the economy by strengthening the forest products industries and agriculture.

Second, interest rates in the United States have fallen sharply this year, continuing the pattern begun in the latter half of 1984. Lower interest rates provide support to the interest-sensitive sectors of the economy, including plant and equipment, consumer durables, and residential structures. This decline in interest rates has been facilitated and encouraged by Federal Reserve monetary policy. On four occasions this year, the discount rate has been cut, for a total reduction of 2 percentage points. These declines have been an important factor in keeping the economic expansion going into what is now its fourth year.

Mortgage rates have shared in the general fall in rates, producing significant expansion in homebuilding. With the support of lower interest rates, construction of single-family houses in the U.S., as well as in Washington, should continue at a healthy rate through the end of next year.

In Washington, residential construction is very strong, with the number of residential construction permits in the twelve months ending last July up 15 percent above the same period a year earlier. The forest products industries in Washington have received a major boost from the housing boom in Washington and throughout the U.S. Nationwide, however, there are signs that the tax reform bill already has begun to discourage new multi-family construction, and I would not be surprised to see multi-family starts down substantially in 1987 compared with this year.

Owing to unused capacity, dislocations in the oil and gas industries, and high office vacancy rates, the decline in long-term interest rates has not yet stimulated business spending for construction and equipment. As in the nation as a whole, nonresidential construction awards in Washington are below 1985 levels. However, I expect more activity of this type throughout the country as the economy begins to expand more rapidly and sales prospects improve.

Areas of Uncertainty

Although most observers would agree that lower interest rates and a lower dollar should boost economic growth, there is growing sentiment that these factors will not prove powerful enough to produce a pickup in the economy. One major concern is how much of an improvement in our trade deficit actually will be provided by the decline in the dollar. Data through the end of June did not give any signs that the trade deficit had begun to improve, even though the dollar had been depreciating for over a year. Moreover, fragmentary data for July raise a question about whether this quarter will have shown any improvement either. However, turning points are notoriously difficult to predict. Missing the turning point in the trade balance by one or two quarters is not enough to shake my confidence in expecting substantial gains in 1987.

Aside from its direct contribution to a pick-up in U.S. economic growth, there is a second reason that a near-term improvement in the trade deficit would improve the U.S. economic outlook. The pressure for increased protectionism, arising from continuing large U.S. trade imbalances and the associated depressed condition of U.S. manufacturing, poses a major risk to U.S. and world economic growth. Protectionist actions in this country could induce retaliatory actions abroad that could lower worldwide demand for goods and services and thereby weaken the prospects for a pickup in economic activity in the U.S. and abroad.

Fiscal policy is another major source of uncertainty in the outlook. The extent to which the Gramm-Rudman deficit-reduction legislation actually will lead to lower federal spending has been a source of speculation in the economic outlook for some time, and these uncertainties were intensified when a key provision of the legislation was declared unconstitutional. For example, if Gramm-Rudman were not implemented at all, the fiscal year 1987 federal budget deficit would be boosted by at least $20 billion above the deficit that would prevail under full implementation of the legislation. This uncertainty regarding federal spending is of particular interest to the Seattle-Tacoma area, where federal defense and space contracts provide a significant number of jobs.

On the revenue side of the budget, the tax reform bill currently before the Congress raises uncertainties about the future performance of the economy. Aside from questions concerning the effect of the legislation on the economy's long-run, or potential, growth rate, there are more immediate questions concerning the impact on real growth next year. The elimination of the investment tax credit, the lengthening of service lives for depreciation, and the elimination of the tax advantages to limited business partnerships will raise the cost of capital for business. Although the reduction in the corporate tax rate will provide some offset, the net effect still is likely to be unfavorable for business investment in the latter part of 1986 and in 1987.

Eventually, this negative factor for growth will tend to be offset by higher household spending in response to lower personal income taxes paid. However, because the tax reforms for individuals are "staggered" -- with taxpayers losing some personal deductions before they enjoy lower tax rates and higher personal exemptions -- the major stimulus to personal consumption is not expected to occur until 1988. Thus this year and next, tax reform should have a net negative impact on GNP, lowering real growth by a cumulative amount of just under 1/2 percent.

A final major source of uncertainty about future economic growth is the extent and duration of dislocation in the oil industry caused by the drop in the price of oil this year. The decline in the price of oil has

hurt Alaska's economy, which in turn has adversely affected companies in Washington that sell products in Alaska. However, prospects for some improvement in the oil industry were enhanced when implementation of new OPEC production quotas caused the price of oil (as measured by West Texas Intermediate crude oil) to jump to the $14 to $16 per barrel range, compared with just over $11 per barrel in late July. Assuming that the price of oil stays at around its present level, major dislocations in the oil and gas industries probably are behind us, and we should see some recovery in employment and capital spending later this year and throughout next year. However, this assessment could turn out to be overly optimistic, since the OPEC agreement to limit production must be considered very fragile.

Uncertainty about the future price of oil also raises a question about what will happen to inflation next year. The dramatic drop in oil prices this year caused both consumer and producer prices actually to fall for the first four months of this year, and should help to keep inflation to around two-and-a-half percent for all of 1986. Next year, however, if the price of oil stays at its present level, the weaker dollar feeding through in the form of higher costs of imports will be the dominant influence on price movements, and inflation could rise at least a full percentage point over its expected rate of increase of 2½ percent this year. However, a collapse of the recent OPEC agreement and consequent fall in oil prices again could mean a significantly lower inflation rate next year.

Challenges to Monetary Policy

In view of the uncertainties in the outlook and the failure of the economy to show definite signs of a sustained, healthy rate of growth, it is tempting to conclude that monetary policy should focus heavily on the side of stimulating growth in real GNP. This temptation is reinforced by the very moderate rates of inflation observed recently.

However, current statistics can be a misleading guide for monetary policy. First, as I pointed out, recent very low rates of inflation reflect the temporary dominance of the oil price shock over the dollar shock. This situation is likely to be reversed next year, so that we could see increases in inflation even if the economy does not pick up strongly.

Second, it takes a certain amount of time for the effects of monetary policy to work their way through to the economy. Complicating matters even further, there are lags in receiving reliable data on what actually has happened to real GNP. Thus a policy of continually lowering interest rates until there is unambiguous evidence about the impact on the economy runs the risk that policy will have been too stimulative, raising the specter of reemerging inflationary pressures.

Against this background, recent rapid growth in the monetary aggregates, which recently has spread from M1 to the broader aggregates, M2 and M3, bears watching. However, the sharp decline last year and so far this year in the rate at which M1 circulates -- its velocity -- has suggested that M1 may not be a very reliable guide to future inflation. This view was reflected in the FOMC's decision that growth in M1 above its target range this year would be acceptable.

But having said this, I also think it would not be wise to totally ignore M1, given its historically close, long-run relation with prices. Moreover, growth in M2 and M3 has been fairly rapid recently, putting M2 only slightly below the upper boundary of its target range and M3 slightly above its upper boundary in August. Growth in these broader aggregates justifies heightened concern about the possiblity of reemerging inflationary pressures in the future.

By my calculations, the easing of monetary policy over the past year should be consistent with the economy making substantial progress towards full employment by the end of next year. But although this outlook is appealing, we must recognize that with the economy poised to move toward a fuller utilization of its resources, there inevitably is a risk that inflationary pressures will re-emerge. Thus, although Federal Reserve policy actions must reflect concern about the current sluggishness of the economy, we must balance this concern against the risk that too much ease might lead to problems with inflation in the years to come. In this way it should be possible to promote sustainable economic growth while at the same time ensuring that continued progress is made toward price stability.