FEDERAL RESERVE BANK
OF SAN FRANCISCO

OFFICE OF
THE PRESIDENT

# THE OUTLOOK FOR THE U.S. ECONOMY AND MONETARY POLICY

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Good afternoon ladies and gentlemen. I appreciate having this opportunity to share with you my thoughts on recent developments in the U.S. economy and on the outlook over the next year and a half.

Thus far, 1987 has been an exciting year, to say the least. Inflation has picked up significantly; the consumer price index, for example, rose at nearly a 6 percent rate in the first four months of this year, versus an increase of only about 1 percent during 1986. At the same time, the overall growth of the nation's output surged to an unexpectedly rapid 4.4 percent pace in the first quarter, substantially more than the two percent rate recorded in 1986.

Financial markets too have had their share of excitement. In recent weeks, bond yields have fluctuated widely from day to day and, on balance, have risen significantly. The yield on 30-year Treasury bonds has risen by 1½ percentage points since the middle of March, and mortgage rates have increased even more. The stock market also has been highly volatile, with the Dow-Jones industrial average registering changes of more than 50 points on seven days in April and May! Meanwhile, the dollar has continued to depreciate, and there has been an unusually close day-to-day relation between changes in the dollar/yen exchange rate and in U.S. bond yields. Finally, amid these developments, on April 30th the Federal Reserve took the unusual step of publicly announcing that it had tightened monetary policy somewhat, and this was followed by actions to ease policy in Germany and Japan.

My main goal today is to put these events in a broader perspective, relating them to longer-run trends in the economy, and to give you my outlook for the economy over the next year and a half. I'll also discuss the dilemmas and challenges posed for the Federal Reserve by recent developments and the economic outlook.

## Setting the Stage

The U.S. economy now is in its fifth year of economic expansion. Since the end of 1982, 12 million jobs have been added to civilian employment, and the unemployment rate has fallen from almost 11 percent to less than 6½ percent. Even more notably, these gains have been accompanied by significant reductions in inflation and interest rates. Measured by the broad-based GNP price index, the inflation rate dropped from almost ten percent in 1981 to 2½ percent last year, while the yield on 30-year Treasury bonds declined from nearly 15 percent in late 1981 to less than 7½ percent earlier this year. The reduction in interest rates has been particularly welcome in Oregon, as wood products activity has buoyed the economy during the past year. These are impressive accomplishments about which we can be justifiably pleased.

These gains, however, mask serious imbalances in our economy. I refer to the huge deficits in our federal budget and in our trade with other nations. In fiscal year 1986, the federal deficit reached $221 billion, up from $79 billion in 1981. Over the

same period, our international balance of trade in goods and services moved from a small surplus in 1981 to a deficit of almost $150 billion last year.

The two deficits are closely related. The trade deficit reflects national spending beyond what the nation produces. The most notable example of this is the steep increase in the federal budget deficit, which has risen from 2.7 percent of our national output in 1981 to 5.3 percent last year. Moreover, the consumer sector has added to the imbalance by increasing its spending faster than its income, so that between 1981 and 1986 personal saving declined from 7½ percent to under 4 percent of after-tax household income. The excessive national spending has been made possible by huge capital inflows from abroad, which are the counterpart of the foreign trade deficit.

Clearly this is an unsustainable situation. No nation can live beyond its means indefinitely by drawing down its investments abroad and by borrowing from other countries. Moreover, as one of the wealthiest nations in the world, we should be *exporting* our savings to less developed countries, not *importing* the savings of others to finance excessive private and public consumption. Sooner or later, we will have to generate a trade surplus in order to service our foreign debts. And the sooner we can begin this process by reducing our excessive domestic spending, the less painful the necessary adjustment in the future will be.

The trade imbalance has caused serious dislocations in many of our industries. From 1981 to 1986, our exports fell five percent in real, or inflation-adjusted, terms while real imports rose more than 50 percent. Agriculture, mining and manufacturing all have been adversely affected by foreign competition, causing dislocations that have hit some regions particularly hard. Although economic conditions have improved in the past year, Oregon is a prime example of a state that has been adversely affected by the high value of the U.S. dollar.

The result of these developments has been a rising tide of protectionism, which threatens the health of the world economy. Trade barriers invite retaliation, raise prices, reduce the volume of trade world-wide, and lower living standards both here and abroad. These barriers are particularly harmful to less developed countries, many of which depend on earnings from exports to pay back and service huge foreign debts.

## Economic Outlook

This year and next, I expect to see reasonably good economic growth in the U.S., and this growth should be accompanied by some improvement in the major imbalances that have plagued the economy. First, I expect the main engine of growth over this period to be an improvement in our trade balance, in response to the depreciation of the dollar since February 1985. I expect the deficit of real (or, inflation-adjusted) imports over exports of goods and services to improve by about $40 billion both in 1987 and in 1988. This would mean that this deficit would be cut

from just under $150 billion in the fourth quarter of last year to less than half of that amount by the end of next year.

In the last couple of quarters we have seen significant improvements in our trading position, so we do appear to be on track with my expectations. International markets for agricultural and forest products -- areas of particular interest to your state -- have displayed particularly heartening improvement. At the Port of Portland, for example, exports of lumber and logs rose 200 and 500 percent, respectively, over year-ago totals. In addition, producers of semiconductors and other high-technology products stand to benefit from improvements in their competitive positions. It is crucial that we continue to make progress in the trade area, since not only will this provide a lift to the economy, but it also should help stem the dangerous protectionist sentiment in the Congress and around the world.

Growth in government spending can be expected to be relatively weak this year and next. The Gramm-Rudman targets for deficit reduction probably will not be met, but I do expect to see decreases in the deficit of about $50 billion in fiscal year 1987 and about $15 billion in 1988.

Although the government sector most likely will be a restraining factor on economic growth in the years immediately ahead, reduced federal deficits are essential for the overall health of the U.S. economy. In fact, without budget-deficit reduction, it is difficult to imagine how we could significantly reduce our trade deficit without encountering serious problems in our domestic economy. As our foreign-trade deficit narrows in response to a weaker dollar, we shall be receiving less savings from abroad. If the government's need for savings is not reduced commensurately, interest rates in this country most likely will rise, hampering the performance of the domestic economy.

Household spending on consumption goods, especially durables, also is expected to be sluggish this year. In part, this reflects the dissipation of the boosts to consumer spending last year resulting from declining interest rates and oil prices. This year, in the absence of these special factors, households are likely to want to restore their saving to a more normal relation to their incomes.

In the short run, higher saving rates will tend to depress consumer-goods industries, just as efforts to bring down the federal deficit hurt government contractors and employees. But in the long run, the nation needs to cut back on consumption in order to release funds for servicing our overseas debts, and to add to the domestic capital formation that is the basis for future economic growth.

Both residential and nonresidential investment also are likely to be sluggish this year and next. Recent increases in long-term interest rates are likely to restrain both of these categories of spending. In addition, several elements of the tax reform legislation that went into effect this year -- the elimination of the investment tax credit and of certain tax shelters, as well as the lengthening of service lives for depreciation purposes -- are putting further downward pressure on investment in

business equipment and construction. Finally, high office and industrial vacancy rates do not bode well for those types of construction. In your own state, the value of non-residential construction awards in the first four months of 1987 was about the same as it was a year ago. If building activity does slow down nationally, Oregon forest products companies are likely to experience reduced demand for their products.

Business investment in inventories is likely to make a significant positive contribution to the average pace of economic growth this year, but most of this already may have come in the first quarter. As I mentioned before, the economy's output of goods and services increased at a rapid 4.4 percent rate in that quarter, and this growth largely reflected increased production that went into inventories (especially of autos). However, inventory investment should drop off to more normal levels in the remainder of the year, so that output growth is unlikely to maintain the rapid rate achieved in the first quarter.

Taking all of these prospective developments into account, I expect the total output of the economy to grow by about 3 percent in 1987 and by 2½ percent in 1988. Some commentators have characterized economic growth in this range as "sluggish," and have pointed out that the economy has a number of weak sectors and regions.

In these circumstances, it is tempting to suggest that the Federal Reserve pursue an easier monetary policy with a view to boosting growth. However, given the likely rate of increase in our nation's labor force and in its productivity, the long-run potential growth rate that our economy can sustain appears to be around 2½ percent. Moreover, by most estimates, the current 6.3 percent unemployment rate is close to "full" employment for the U.S. economy. Thus growth in excess of what I expect this year and next could move the economy dangerously close to capacity constraints, at least in terms of labor, and in that circumstance, we could face a serious inflation problem.

## Inflation Outlook

Even if output grows at the moderate pace I expect, the inflation rate, as measured by the broad-based GNP price index, is likely to average around four percent this year and next, significantly above the 2½ percent rate recorded last year. Inflation was held down temporarily by the sharp drop in the price of oil early last year. This beneficial effect has now passed, and in fact oil prices have been moving up since the middle of last year.

Prices in the U.S. also are being pushed up by the depreciation of the dollar, which is raising the cost of imported goods and services. In the first quarter, the average prices of our imports rose at an annual rate of 14 percent. I expect this pattern to continue as the effects of the dollar's depreciation over the last two years work themselves through the economy. Unfortunately, the inflationary effects of the dollar's depreciation are a necessary part of the mechanism by which the trade deficit is brought down.

Recent increases in medium- to long-term bond yields seem to reflect this prospect of more inflation, as investors require higher returns to offset the expected decline in the purchasing power of those returns. In the last couple of months, there has been a close day-to-day relation between changes in the value of the dollar (especially vis-a-vis the Japanese yen) and changes in U.S. bond yields; and on balance, the sharp increase in bond yields has been associated with a significant depreciation of the dollar. This pattern suggests that the bond markets recognize that exchange-rate movements will influence the inflation rate for several years. But it also may reflect concern about whether the Federal Reserve has the resolve to prevent a more persistent inflation problem from developing.

Although I expect higher inflation this year and next, this need not be the beginning of an upward spiral of prices. Once the dollar has stabilized, the upward pressure on import prices, and hence on domestic inflation, gradually should subside.

However, there is a danger that temporary increases in inflation will become embedded into inflation expectations, and in turn into longer-term wage and price contracts. If this were to occur, we could find ourselves faced with a more persistent problem with inflation. As I will discuss in a moment, this possibility places an especially heavy burden on the Federal Reserve this year in choosing an appropriate monetary policy.

## Monetary Policy

In designing monetary policy, the Federal Reserve often is faced with the problem of balancing the demands of competing goals. This year is no exception. As always, we recognize the need to promote the continuation of the current economic expansion.

However, with rising import costs tending to push up the average level of prices, and with the economy near full employment, it is especially important that the Federal Reserve avoid overly-expansionary policies that might make the economy expand too rapidly. If the effects of the increase in import prices were to be reinforced by strong domestic demand for goods and services, this would add to the likelihood that higher import prices would spill over into persistent domestic wage and price inflation.

To avoid this problem, it is essential this year that the Federal Reserve be cautious in its provision of liquidity to the economy. Our decision in February to reduce the 1987 target ranges for growth in the monetary aggregates, M2 and M3, by $\frac{1}{2}$ percent to $5\frac{1}{2}$ to $8\frac{1}{2}$ percent, was a signal of our resolve to continue to meet our commitment to keep inflation under control.

The tightening of policy announced by Chairman Volcker on April 30 also is in line with these concerns about inflation. As I have discussed, the decline in the dollar since early 1985 can be expected to add significantly to both inflation and economic growth this year and next. If the dollar were to fall sharply from present

levels, inflation could rise considerably above the 4 percent rate I expect, while a more rapid improvement in the trade deficit could cause the economy to "overheat." The recent tightening of monetary policy in the U.S., in combination with reductions in interest rates in Japan and West Germany, should cushion the decline of the dollar, and thus temper potential excessive pressures on economic growth and inflation.

In conclusion, although the Federal Reserve's policy actions must seek to maintain the economic expansion, there is good reason this year to emphasize concern about a renewed threat of inflation. By so doing, the Federal Reserve can continue to make progress toward its goal of ultimately achieving price stability.