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 marked by a number of ominous economic developments. Inflation has picked up significantly; the consumer price index, for example, rose at a 5 1/2 percent rate in the first six months of this year, versus an increase of only about 1 percent during 1986. 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 about 1 1/4 percentage points since the beginning of this year, and mortgage rates have increased by a similar amount. The international value of the dollar also has been highly volatile, declining sharply through May, but then reversing that trend in June and July. Moreover, since April there has been an unusually close day-to-day relation between changes in the Dollar/Yen exchange rate and U.S. bond yields.

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, more than 13 million jobs have been added to civilian employment, and the unemployment rate has fallen from almost 11 percent to just over 6 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 2 1/2 percent last year, while the yield on 30-year Treasury bonds declined from nearly 15 percent in late 1981 to less than 7 1/2 percent earlier this 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 rose 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 7 1/4 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, and has hit some regions particularly hard. From 1981 to 1986, our exports fell 5 1/2 percent in real, or inflation-adjusted, terms while real imports rose more than 50 percent.

The result of these developments has been a rising tide of protectionism, which threatens the health of the world economy. Trade barriers, however, 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 around $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.

We have seen a significant improvement in our trading position since the third quarter of last year, so we do appear to be on track with my expectations. International markets for fish and forest products -- areas of particular interest to Alaska -- have displayed especially heartening improvement. These industries also have benefited during the last year from strengthening domestic demand for their products. 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 according to recent estimates of both the Administration and the Congressional Budget Office, the deficit probably will decline to the $170 to $180 billion range in fiscal year 1988 from $221 billion in 1986. Although such a large deficit next year would be disappointing, at least some progress at deficit reduction does seem likely.

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 a lower budget deficit, 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, with interest rates and oil prices on the rise, households are likely 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. Housing starts have declined in every month since February and in the first six months were more than ten percent below the same period last year. 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 -- caused a sharp reduction in purchases of business equipment in the early part of the year, but we expect this to be temporary. However, high office and industrial vacancy rates do not bode well for those types of construction. In Alaska, the value of non-residential construction awards began falling sharply in early 1986, but fortunately the interest-rate movements since then appear to have had no additional impact on activity.

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. The economy's output of goods and services was significantly boosted in that quarter by 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 pace 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 or slightly less in 1987 and by 2 1/2 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 2 1/2 percent. Moreover, by most estimates, the 6.1 percent unemployment rate registered in June is close to "full" employment for the U.S. economy. Thus if the economy were to grow much more rapidly than I expect this year and next, it could run into capacity constraints, at least in terms of labor. 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 2 1/2 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. Just in the past month, the price of West Texas Intermediate has risen from around $20 a barrel to over $22 a barrel. Unless some of this recent increase is reversed, inflation is likely to be even higher than the four percent rate I expect for 1987 and 1988.

While higher oil prices create concern on the inflation front, they obviously are good for Alaska's economy, stimulating it both directly, through increases in oil drilling and exploration activity, and indirectly, through increases in state revenues that feed through Alaska's important state and local government sector to the State's broader economy.

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 and a half 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.

Although inflation already has begun to rise because of the relative-price factors I mentioned, this has not yet begun to show up in underlying inflation factors such as longer-term wage and price contracts. However, we currently face the danger that the increases in inflation I expect this year and next will become embedded into inflation expectations, and in turn into underlying inflationary pressures. If this were to occur, we could find ourselves faced with a 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 last February to reduce the 1987 target ranges for growth in the monetary aggregates, M2 and M3, by 1/2 percent to 5 1/2 to 8 1/2 percent, was a signal of our resolve to continue to meet our commitment to keep inflation under control. These target ranges were reaffirmed last week in our monetary policy report to Congress -- the Humphrey-Hawkins Report, as it is called. Moreover, as part of his Humphrey-Hawkins Congressional testimony, Chairman Volcker noted that the Federal Reserve had tightened monetary policy in April and again in May by reducing the availability of reserves to banks and other depository institutions. He noted that these actions had helped to stabilize the dollar and moderate concerns about inflation. Finally, the Federal Reserve signalled its resolve to continue to keep the lid on inflation in 1988 by announcing its plans to reduce the M2 and M3 target ranges for that year by a further 1/2 percent to 5 to 8 percent.

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.