FEDERAL RESERVE BANK OF SAN FRANCISCO

OFFICE OF THE PRESIDENT

THE OUTLOOK FOR THE U.S. ECONOMY

CLOUDS ON THE HORIZON

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Good morning ladies and gentlemen. I appreciate having this opportunity to share with you my thoughts on the outlook for the U.S. economy over the next year or so and on the major issues facing the Federal Reserve in designing monetary policy.

In some respects, this has been a good year for the U.S. economy. Now about to begin its sixth year, the current economic expansion is the second longest since World War II. The economy has expanded at a healthy pace this year, and the unemployment rate has dropped from 6 3/4 percent to slightly under 6 percent. However, these gains have been accompanied by the persistence of serious imbalances in our economy that sooner or later will have to be dealt with. I refer to the huge deficits in our federal budget and in our trade with other nations and to the small proportion of incomes saved by the private sector. The effects of these persistent imbalances increasingly are showing up in higher inflation and interest rates and in more volatility in domestic and international financial markets.

As I will suggest in my remarks today, these problems have important implications for the outlook for the economy over the next year and beyond, and pose challenges for Federal Reserve monetary policy.

IMBALANCES

Last year's federal deficit of $221 billion amounted to 5.3 percent of our national output, compared to 2.6 percent in 1981. As the federal deficit has risen, our international balance of payments with other countries also has deteriorated, moving from a small surplus in 1981 to a deficit of more than $140 billion last year.

These two deficits are related. The international deficit reflects domestic spending on goods and services beyond what the nation produces, and the steep increase in the federal budget deficit is the most important example of this excessive spending. However, the private sector also has added to the imbalance by increasing its spending faster than its income. Between 1981 and 1986, personal saving declined from 7 1/2 percent to 4 1/4 percent of after-tax household income. Even when saving by corporations and through government pension funds is added, private saving was less than ten percent of private after-tax income last year, the lowest rate of saving since the years immediately after World War II. Unfortunately, the surpluses of our state and local governments make only a small contribution toward reducing the savings shortfall.

The excessive spending by the private and government sectors has been made possible by huge capital inflows from abroad, which are the counterpart of the rising deficit in our trade and payments with the rest of the world. From 1981 to 1986, our imports of goods and services rose by more than 37 percent, while exports declined 3 percent. In other words, being unable or unwilling to do an adequate amount of saving ourselves, we have supplemented our own resources by drawing down our investments abroad and by borrowing from other countries. Clearly, this is an unsustainable situation, since no nation can live beyond its means indefinitely.

Although the strong domestic demand for goods and services has provided a major impetus to economic expansion, the trade imbalance has caused serious dislocations in a number of our industries, and has hit some regions particularly hard. These dislocations have led to rising demands for protection against foreign competition. Protective trade barriers, however, are very costly to the vast majority of U.S. citizens, and they invite retaliation. A trade war would reduce the volume of world trade, raise prices, and lower living standards here and abroad. Trade barriers are particularly harmful to less developed countries, many of which depend on their earnings from exports to pay back and service huge foreign debts.

The effects of the excessive domestic spending and inadequate saving also have shown up in the nation's financial markets. Although nominal interest rates have fallen substantially in recent years, this decline mainly reflects lower inflation. Real interest rates, after correcting for the effects of inflation, have been much higher in the 1980s than they were ten years ago. Moreover, with the U.S. economy now so strongly affected by its imports and exports and so dependent on the inflow of funds from abroad, our domestic financial markets have become more sensitive to developments in the foreign-exchange markets. Much of the increased volatility in our interest rates this year appears to have been in reaction to gyrations in the foreign-exchange value of the dollar.

Economic Outlook

I expect to see reasonably strong economic growth in the U.S. in the remainder of this year and in 1988. As a result, the economy will continue to generate sufficient new jobs to hold the unemployment rate at around its current 6 percent level. It seems likely that spending by domestic sectors will grow only modestly -- implying some increase in private saving -- and that the major impetus to growth will come from an improvement in the foreign trade deficit. Thus there is a good chance that next year's growth will be accompanied by some improvement in the imbalances that have plagued the economy. However, such an improvement is by no means certain.

An important example of this uncertainty concerns prospects for an improvement in the low rate of personal saving. For several years, household outlays on consumption goods have grown very rapidly, and the personal saving rate has dropped sharply. Last year, declines in interest rates and in oil prices encouraged households to boost their outlays at the expense of saving. This year, however, with interest rates and oil prices on the rise, households should begin to show signs of restoring their saving to a more normal relation to their incomes by slowing their pace of spending. In the first half of the year, consumption spending did slow down -- it increased at an annual rate of only 1.4 percent, compared to 4.1 percent during 1986. However, it appears that in the third quarter this slowing was reversed, with consumption increasing at a very rapid pace.

I hope, and expect, that this most recent development is only a temporary departure from a trend toward slower growth in consumption and a faster rise in private saving. The immediate effect of higher saving rates would be to depress the consumer-goods industries. But over the longer run, the nation needs to cut back on the growth of consumption in order to release funds for servicing our overseas debts and to add to the domestic capital formation which is the basis for future economic growth.

The recent increases in interest rates also are likely to restrain spending on both residential and nonresidential investment this year and next. Residential building declined at a five percent annual rate in the first half of this year. I anticipate a similar rate of decline in the second half and essentially no change next year. Similarly, I expect construction spending by businesses to decline this year and to increase only slightly next year. In addition to the depressing effects of higher interest rates, high office vacancy rates do not bode well for this type of construction. Although business spending on equipment should be relatively strong next year, the anticipated drop in spending on structures will hold the overall increase in plant and equipment investment to a moderate 2 percent in inflation-adjusted terms.

Government spending on goods and services is expected to show little if any growth over and above inflation this year and next. In the fiscal year just ended, the federal deficit is estimated to have been in the neighborhood of $160 billion. Although this is a substantial improvement over the $221 billion deficit in 1986, part of the reduction was the result of a one-time surge in capital gains taxes last winter in anticipation of tax reform, and of various other one-time factors such as sales of federal assets. As a result, the Congressional Budget Office projected recently that the deficit, on a current-services basis, will rise again in 1988 to nearly $185 billion. This projection looks optimistic because the interest-rate assumption underlying the CBO's estimate appears to be on the low side. On the other hand, as part of the legislation extending the federal debt limit, the Congress and Administration recently agreed to a $23 billion reduction in the deficit for 1988 below the level implied by the current-services budget. However, it has not yet been determined what expenditure items or taxes will be changed in order to achieve this deficit reduction.

Although experience in recent years has taught us that cuts in the deficit can prove to be elusive, I am assuming that federal outlays in this fiscal year will be below the levels in the current-services budget by the amount specified in this legislation, implying a deficit of about $160 billion. I recognize, however, that there is considerable uncertainty in this area and that this assumption may turn out to be unduly optimistic.

Although domestic demand by the private and government sectors combined will rise by less than two percent in the coming year, I expect an improvement in our foreign trade position to add a further one percent to the economy's overall growth rate. 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 $35 billion both in 1987 and 1988. This would mean that this deficit would be cut from just under $150 billion in the fourth quarter of last year to around $80 billion by the end of next year.

Substantial improvement in the trade balance was registered in the final quarter of last year and the first quarter of this year. More recent figures have presented a less optimistic picture of our trade situation, with net exports (adjusted for inflation) improving by only $2 1/2 billion in the second quarter and probably deteriorating somewhat in the third. However, these results partly reflect a surge in imports of crude oil, as inventories are being built up in response to the tense situation in the Persian Gulf. Although it is true that imports of manufactured goods also increased in this period, providing some room for doubt about how much improvement in the trade balance actually will occur, I remain optimistic that we will make progress in the trade area in the remainder of the year and in 1988. This progress is important if we are to stem the dangerous protectionist sentiment in the Congress.

Taking all of these prospective developments into account, I expect the total output of the economy to increase by between 2 1/2 and 3 percent both this year and next. In the early stages of a business expansion, growth at this rate would be barely acceptable. But, in the present "mature" phase of the upswing, more rapid growth would lead to problems. By most estimates, the most recent unemployment rate of 5.9 percent is close to "full" employment for the U.S. economy. Moreover, 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. Thus if the economy were to grow much more rapidly than I expect next year, it soon would run into capacity constraints, at least in terms of labor. If that were to occur, we would 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 run in the 4 to 4 1/2 percent range through the end of next year, a significant worsening from the 2 1/2 percent rate 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 for more than a 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. Over the first two quarters of this year, the average prices of our imports rose at an annual rate of almost 11 percent. Unfortunately, this effect of the dollar's depreciation in raising import prices is a necessary part of the mechanism by which the trade deficit is brought down. In part, the increases in medium- and long-term bond yields this year seem to reflect this prospect of higher inflation as investors require greater returns to offset the expected decline in the purchasing power of those returns.

In 1988, it appears that the effects of these influences on inflation will begin to lessen. However, given the present degree of labor market tightness, there is good reason to expect that wages and other labor costs will begin to rise at a faster pace. It seems likely that compensation per hour could increase at a rate of around 4 1/2 percent next year, following a much smaller increase in the range of 2 1/2 to 3 percent this year. Thus although inflation in 1988 may remain in a range similar to this year's rate, the sources of inflation are likely to be different. To the extent that inflation next year reflects underlying wage increases, rather than movements in the dollar and oil prices, we will find ourselves faced with a more persistent inflation problem.

Monetary Policy

The inflation outlook, and the problems it poses for the Federal Reserve, would be significantly worsened if the reductions in Federal government spending that I have assumed for 1988 do not materialize. In that event, and in the absence of an offsetting tightening of monetary policy, real output growth in 1988 could be boosted by as much as one percentage point and the rate of inflation by one-half percentage point. Perhaps more importantly, the risk of a permanent ratcheting upward in the inflation rate in later years would be much greater.

This risk of more rapid inflation reflects an underlying tension developing in the U.S. economy. With the trade balance projected to improve substantially in 1988 in response to the decline in the dollar, spending in some domestic sector must slow, if we are to avoid a situation in which output growth accelerates sharply and the economy is pushed against its capacity constraints. I hope that this reduction in domestic demand can come from cuts in the federal budget. But, as I pointed out earlier, it is by no means certain that these cuts will be achieved. If they are not, the pace of spending on U.S. goods and services could exceed the economy's capacity to produce. Under such circumstances, the Federal Reserve's goal of keeping inflation under control inevitably would be threatened.

This situation is related to the problems of the budget and trade deficits, and the shortage of domestic savings that I discussed earlier. If the growth of federal outlays is not slowed next year, while at the same time an improvement in the trade balance reduces the inflow of foreign capital, there will be a serious imbalance between the demand for savings and the available supply. The relatively low availability of savings in the financial markets would tend to drive up interest rates. Of course, the Federal Reserve temporarily could prevent such increases in interest rates by supplying more funds to the market through expansionary monetary policy. However, this approach would not work for long, since the inevitable result would be higher inflation, which in its own way would drive up interest rates.

The Federal Reserve is not in a position to resolve the imbalances I have discussed -- in the federal budget, in private saving, and in our foreign trading position. Instead, we can only react to the situation at hand and try to design policies that lessen potential problems. In current circumstances, I believe that it is especially important for the Federal Reserve to be cautious in its provision of liquidity to the economy. With rising import costs tending to push up prices, with the economy already close to full employment, and with the risk that little progress will be made in reducing the federal deficit, there is good reason for the Federal Reserve to emphasize concern about a renewed threat of inflation in its conduct of monetary policy.

Our decision last July to reduce the 1988 target ranges for growth in the monetary aggregates, M2 and M3, by 1/2 percent to 5 to 8 percent, was a signal of our resolve to continue to meet our commitment to keep inflation under control. The Federal Reserve already had tightened monetary policy in April and May by reducing the availability of reserves to banks and other depository institutions. Early last month, policy was tightened a notch further by a half-point increase in the Federal Reserve's discount rate. This action appears to have helped to stabilize the dollar and to moderate concerns about inflation.

Even though the outward signs of economic growth and employment currently are relatively up beat, I believe that the economy is entering an especially hazardous period. The Federal Reserve can make its best contribution toward minimizing the risks to our economic future by focusing on its responsibility to keep inflation under control and eventually to achieve price stability.