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The Economy in 1989: A Test of Our Resolve

I. Introduction

   A. Plan to speak briefly on the outlook for the economy and the challenges for policy

   B. Want to stimulate questions and comments

II. I've got good news and bad news

   A. Good news: economy's vital signs are strong

   B. Bad news: inflationary pressure is rising

   C. The good news/bad news present challenges for the Fed:

      1. Resist inflationary pressures

      2. Foster growth at a slower, more sustainable pace

III. First, the good news

   A. The past 5 1/2 years have been a period of strong expansion for the economy.

      1. Employment growth has been extraordinary, with 1.3 million new jobs added so far this year.

2. Net exports and business equipment investment have been main engine for continued expansion.

   a. Trade deficit is falling.

   b. Durables manufacturing and agriculture are rebounding strongly.

3. Even in Alaska, where things haven't been so good, the economy appears to have reached bottom, and tourism, fisheries, and metal mining should provide modest growth.

B. Overall, strength of economy continues to surprise economists.

1. They keep revising forecasts of second half of 1988 upward.

   a. Third quarter, especially, likely to be strong.

   b. Expect growth for 1988 to come in at 3 1/4%

2. Growth in 1989 expected to slow, but still remain healthy.

IV. Now, the bad news (the inevitable corollary to the good news).

A. Inflationary pressure is rising.

1. Evident in broadest measure of prices -- GNP fixed-weighted price index. (in 88:2 rose to 4.7% from its average of 3.7% since mid-87)

2. Wages, salaries, and benefits (measured by the Employment Cost Index) rose 5.5% in 88:I, vs. 3.3% in 1987. (This includes large rise in benefits.)

B. Measured inflation rates this year and next will be buffeted by transitory shocks.

1. Strengthening dollar in foreign exchange markets and softer oil prices temporarily will reduce inflation.

2. Drought and rising food prices will add as much as 1/2 to 1 percentage point to inflation through the end of June 1989.

C. More worried that underlying pressures are intensifying.

1. Economy is growing faster than growth in productive capacity.

2. Capacity utilization, at 83.5%, is high by historical standards.

3. Employment increases have taken us into range of full employment.

4. This is the environment where, experience tells us, wages and prices begin to accelerate.

D. Taking all these factors into account, foresee inflation upwards of 5% (GNP fixed-weighted price index) in 1989.

V. That's intolerable for three reasons:

A. First, rising inflation, as the 60's and 70's showed, stunts economic growth by causing many distortions.

B. Second, bitter experience of late 70's and early 80's tells me that once inflation gets imbedded in expectations, it's costly to root out. Price tag was:

   1. High interest rates;

   2. Two back-to-back recessions; and

   3. Postwar record unemployment rates.

C. Third, I believe that vigilance in controlling inflation now can save us a repeat of the 70's and early 80's.

VI. Fed is being tested in its ability to perform careful balancing act:

   A. The Fed needs to :

      1. Keep inflation under control; and

      2. Sustain economic growth at a pace more consistent with long-run growth in productive capacity -- about 2.5%, instead of 5% in '87 and the 3-3.5% rate we've seen recently.

   B. A former Fed Chairman once said that the Fed's job is to take the punchbowl away just when the party's getting good. Actually, we're not planning to take it away, just not refill it so often.

      1. Recent discount rate hike reflects Fed's determination not to let inflation accelerate.

2. Interest rates have been rising since mid-spring, in part because of of the strong economy and a series of modest tightening moves by Fed.

C. Financial markets have responded favorably to these efforts:

1. Exchange value of the dollar has risen about 10% since April.

2. Long-term rates, though rising, generally have not risen as fast as short rates since March, possibly reflecting lower inflation premia. (Long-term rates shot up from 9.1 to 9.36% yesterday, but the spread between short and long rates remains lower than it was in March.)

VII. Summing things up,

A. Expect economy in 1989 to slow, but remain very healthy, despite current, higher level of interest rates.

B. Slower growth will help to reduce inflationary pressures.

C. Fed will need to remain vigilant on the inflation front to avoid problems of accelerating inflation.

D. But some preventive medicine now will avoid a far more costly cure later.