Rotary Club of Walla Walla
September 29, 1988

The Economy in 1989:
A Good News and Bad News Story

I. Introduction

A. Plan to speak briefly on the outlook for the economy and the challenges for money and credit policies of the Federal Reserve.

B. Want to stress that a lot of cross-currents are buffeting the economy right now. These cross-currents add considerable uncertainty to economic prospects for the new year.

C. Also, want to stimulate your questions and comments. Would appreciate your input, especially at this time.

II. In general, I've got a good news and bad news story.

A. Good news:

1. Economy remains healthy and shows some signs of slowing down to a more sustainable rate of growth.

2. Also, declines in oil prices and the rise in the dollar, if sustained, will hold inflation down next year.

B. Bad news:

1. Strong dollar, if sustained, will delay needed adjustment in trade balance.

2. Underlying inflationary pressures still on the rise, and there is the risk that the economy will not slow enough to relieve these pressures.

C. The good and bad news situation presents challenges for the Fed, particularly since cross-currents from the dollar and price of oil raise major uncertainties about the economic outlook; it is very difficult to know what will happen to both oil and the dollar.

III. Let me turn first to the good news:

A. The past nearly six years have been a period of strong expansion for the economy.

1. Employment growth has been extraordinary, with nearly 18 million jobs created since 1982:4 and almost 2.5 million new jobs added so far this year.

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

a. Trade deficit has been falling.

b. Manufacturing and agriculture have been rebounding strongly -- at least until the drought began to pinch.

3. In the Walla Walla area, as you know, things have been looking up.

a. The unemployment rate (taking seasonal influences into account) has been falling for the past few years.

b. Also winter wheat production in this area hasn't been affected by the drought and wheat prices are up because of the drought in the rest of the country.

B. Overall, resilience of the U.S. economy has surprised economists.

1. Longest peacetime expansion in U.S. history, despite stock market crash.

a. We had 5% growth in 1987 and expect close to 3% this year.

b. We've seen a few signs of slowing since August, but we don't know how much weight to put on these new developments.

c. Frankly, I do expect that growth will be slower and average 2 to 2 1/2% in 1989.

d. Might add that the drought will shave about 3/4% off this year's growth and add about the same amount to next year if weather conditions return to normal.

2. Let me stress that a slower economy in 1989 falls into the "good news category" because it will tend to restrain inflationary pressures in the future and therefore is healthier for the economy in the long run.

C. Also in the good news category are two factors <u>temporarily</u> putting downward pressure on rate of inflation: dollar and oil.

IV. With all this good news, you're probably wondering what's the bad news: Basically its the trade deficit and inflation.

A. Strong dollar threatens continued adjustment of trade imbalance by reducing net exports. Makes need to reduce federal budget deficit all the more pressing.

B. Strong growth of economy in recent years has created worrisome inflationary pressures.

1. Oil and dollar will help out temporarily, but <u>only if</u> dollar doesn't fall and oil doesn't rise -- a thin reed to hang hopes on.

2. Most importantly, <u>underlying</u> pressures are still with us.

   a. Evident in broadest measure of prices -- GNP fixed-weighted price index. (In 88:2 rose to 5.0% from its average of 3.7% since mid-87)

   b. Wages, salaries, and benefits (measured by the Employment Cost Index) rose 5.7% in first half of '88, vs. 3.3% in 1987. (This includes large rise in benefits.)

C. We cannot afford to be lulled into forgetting about inflation.

   1. The economy <u>still</u> is growing faster than growth in productive capacity;

   2. Manufacturing capacity utilization, at 83.8%, is very high by historical standards; and

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

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

V. We cannot tolerate higher inflation for at least 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 from a repeat of the 70's and early 80's.

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

A. The Fed must:

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%.

B. A former Fed Chairman once said that the Fed's job is to take the punch bowl away just when the party's getting good. Actually, our job is not take it away, just refill it less often.

1. Until very recently, interest rates had been rising gradually since mid-spring, in part because of the strong economy and a series of modest tightening moves by Fed.

2. Discount rate hike in August reflects Fed's determination not to let inflation accelerate.

C. Financial markets have responded favorably: long-term rates generally have not risen as fast as short rates since March and actually have fallen in recent weeks, possibly reflecting lower inflation premia.

VII. Summing things up,

A. Expect economy in 1989 to slow, but remain healthy, despite the increase in interest rates since early this Spring.

B. Slower growth will help to reduce inflationary pressures. Strong dollar and lower oil prices may reinforce this.

C. But Fed will need to remain vigilant on the inflation front.