

**FEDERAL RESERVE BANK
OF SAN FRANCISCO**

**OFFICE OF
THE PRESIDENT**

THE SHAPE OF THE U.S. ECONOMY IN 1989

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Good morning, ladies and gentlemen. It's a pleasure to share my views on the outlook for the U.S. economy next year. I believe the prospects for growth are quite good. As I see it, recession is not an issue we'll have to face in the immediate future. Rather, the issues for 1989 are whether growth will be balanced, noninflationary, and conducive to the longer-run health of the economy. I'll begin with a brief review of the economy's recent performance. This sets the stage for a discussion of the key concerns I have as we stand on the threshold of a new year. Then I'll sum up with my view of what this means for the economy and monetary policy in 1989.

Review

The past six years have seen a strong expansion in the U.S. economy -- the longest peacetime expansion in U.S. history. Eighteen million jobs have been created since the business cycle trough in 1982. The unemployment rate has fallen to a fourteen-year low of 5 1/4 percent. At the same time, consumer price inflation has been brought down from a peak of nearly 15 percent in 1980 to 4 percent over the past twelve months.

In 1987, real output grew by 5 percent, a remarkably robust performance for an economy in its fifth year of expansion. The economy slowed modestly to a 3 1/4 percent rate of growth in the first half of this year. This is still surprisingly strong, considering that it followed the October 1987 stock-market crash.

Improvement in our foreign trade balance has been an engine for growth in the past year and a half. Spending by businesses on durable equipment, and consumer spending on services and durable goods also kept things moving along.

Since midyear, the economy has been showing some signs of further slowing. Output grew at a 2 1/4 percent annual rate in the third quarter. A good part of this slowdown reflected the temporary effects of the drought on agricultural production. The effects of this decline in agricultural production will be felt through the fourth quarter. However, we're also seeing signs of renewed strength in the recent monthly numbers on employment, retail sales, and industrial production. I am concerned that the slowdown in the economy may be more apparent than real.

From my perspective as a central banker, a slowing trend is, on balance, desirable. Recall that in the Summer of 1987, the Federal Reserve was concerned that the economy was in serious danger of "overheating." The unemployment rate was dropping and capacity utilization was rising -- both into ranges that signalled the economy was approaching its maximum capability to produce goods and services. Long-term interest rates were rising, reflecting the market's concern about future inflation. So, the Fed raised the discount rate in September 1987 from 5 1/2 percent to six percent to make clear our intention to cool things off a bit.

The stock-market crash in October required a detour in the course of monetary policy. As fears of recession rose, the Fed quickly eased its reins on credit and provided the liquidity needed by the financial and economic system. By March of this year, however, the threat of recession largely had passed, and

the Fed returned to its anti-inflation course.

Since then, we have raised the discount rate another 1/2 percent to 6 1/2 percent. Interest rates have risen modestly partly as a result of a series of tightening moves. Overall, financial markets have responded favorably to our efforts: long-term interest rates have not risen as fast as short-term rates, reflecting lower expectations of inflation. Moreover, the modest slowdown in the economy has helped to curb demands for credit and has kept interest rates from rising further.

Key Concerns

The modest slowing in the third quarter is heartening because it moves the economy closer to a pace that can be sustained in the long run without higher inflation. But the pattern of growth in the third quarter is worrisome. Consumer and government spending remained strong at the same time that business spending on plant and equipment tapered off sharply. Likewise, our trade balance (adjusted for price changes) worsened for the first time since the end of 1986.

This pattern of growth illustrates the persistent and dangerous structural imbalances in our economy that have developed in the current expansion. By "structural imbalances," I mean the federal-budget and trade deficits, and the low personal saving rate. The combination of strong spending in the private sector and unprecedented deficits in the federal government's budget have outstripped our nation's saving and productive capacity. As a result, we have had to rely on imports of foreign goods and foreign funds to make up the shortfall. As a nation, we simply have been (and still are) spending beyond our means.

Foreign financing has enabled us to do this, but let's be blunt about what's happening: we are mortgaging our future income, and the income of our children, to pay for this spending spree. Of course, as every homeowner in California knows, a big mortgage is not so onerous when we expect our incomes and wealth to rise. But I worry when I look at how we're spending the money. The combination of continued strength in consumption and government spending is troublesome. And, although business investment in plant and equipment has been robust in recent years, it has not been particularly strong compared to previous expansions. We're simply not investing enough in productive capacity to boost our future income and cover the rising foreign debt service. This situation spells trouble for future standards of living, and will only get worse the longer the imbalances persist.

Another problem with these imbalances is that they have made U.S. economic developments highly sensitive to changes in the foreign-exchange value of the dollar. The dollar has risen on balance since the end of last year, after falling sharply over the previous three years. The higher dollar in the past year is having a depressing effect on the economy as it slows the improvement in our trade deficit. Of course, this economic slowdown actually is beneficial in one respect: it is helping to keep inflation under control and reducing upward pressure on interest rates. But the higher dollar also is slowing the needed adjustment in our trade deficit and increasing our foreign debts.

Conversely, a weaker dollar would help out on the foreign trade front, but also would have a downside: a lower dollar would increase inflationary and interest-rate pressures. In effect, the dollar has become a "catch-22" for the U.S. economy. If it falls, it creates inflation, and if it rises it delays the needed adjustment in our foreign deficit.

Some have embraced trade barriers as a way to reduce the trade deficit. I want to emphasize that this approach would be disastrous. The kind of trade protectionism embodied in the recent textile bill, for example, invites retaliation, thereby threatening the world-wide economic expansion, and raises prices in the U.S. without helping our overall trade situation.

There is, however, one sure way out of our bind: reduce the federal budget deficit. Reducing the budget deficit would lower the demand for foreign funds as well as the demands on the economy's resources. This would allow the dollar, the trade deficit, and interest rates to subside simultaneously. It also would set the stage for more balanced and sustainable economic growth over the long run, and thus enhance the chances of sustaining the expansion well into the next decade.

Prospects for reducing the deficit are very difficult to assess. The projections of the Administration and the Congressional Budget Office present very different pictures. The Administration expects that Gramm-Rudman-Hollings spending cuts will reduce the deficit by about \$25 billion per year over the next five years and bring the budget close to balance in 1993. The CBO sees improvements of only \$7 billion per year. These differences rest mainly on alternative assumptions about economic developments over the next five years, and my outlook is closer to that of the CBO.

But more important than differences in economic assumptions are the actions the new Administration will take to reduce the deficit. Unfortunately, the gargantuan off-budget liability of the Federal Savings and Loan Insurance Corporation won't help matters. Estimates of the cost of dealing with all the insolvent S & Ls run as high as \$100 billion! But despite these problems, it is imperative that strong actions be taken -- and soon -- to set the deficit on a decidedly downward course.

Price Stability

There is very little the Federal Reserve can do to correct the imbalances I have described. We simply must deal with the situation as it is. Until concrete progress is made in lowering the budget deficit, we are stuck with structural imbalances that foster underlying inflationary pressures. Although overall inflation has not accelerated this year compared to 1987, there have been disquieting signs of a pick up in wages, salaries, and benefits. The most comprehensive measure of labor compensation rose by 4 1/2 percent over the twelve months ending last September, versus less than 3 1/2 percent over the prior twelve months. Although part of this increase was due to special factors, the figures do suggest that underlying wage pressures are rising in response to today's low unemployment rate.

Now, I don't want to give the impression that inflation is about to return to double-digit levels. For one thing, the combination of a higher dollar and lower oil prices this year provide some temporary relief. But we can't depend on factors beyond our control -- like the dollar and the price of oil -- to solve our inflation problem for us. And we should not shy away from corrective medicine while the problem is still manageable.

But some may wonder, "what's wrong with a little inflation if reining it in means we have to accept slower economic growth?" The problem is, a little inflation has a disturbing tendency to turn into a lot of inflation. Inflation stunts economic growth and exacerbates business cycle swings. And the experience of the early 1980s showed that once inflation gets embedded in expectations, it's difficult to root out. It took two back-to-back recessions, soaring interest rates, and postwar-record unemployment to tame inflation the last time around.

For this reason, we need to make steady progress towards price stability. Now that we're operating in the range of full employment, the economy can't afford to grow faster than the rate of growth in our long-run capability to produce goods and services. This means that we need to avoid growth next year (and over the next several years) in excess of 2 1/2 percent. The economy's structural imbalances may tend to push us higher than that, but the Fed must resist these pressures.

Looking Ahead

Fortunately, the monetary tightening so far and the behavior of the dollar this year should restrain economic growth in 1989. Whether these factors alone will be sufficient to hold economic growth to a sustainable rate of under 2 1/2 percent next year remains to be seen. I expect to see prices (as measured by the fixed-weight GNP price index) rise at about a 4 percent rate in 1989, about the same as this year. However, this is hardly cause for celebration, particularly because we've been lucky. Favorable movements in the dollar and the price of oil this year should keep inflation from rising next year. In any event, underlying wage inflation may continue to accelerate next year.

As I said at the outset, the key issue in 1989 will be whether growth next year is balanced and conducive to the longer-run health of the economy. Unfortunately, the prospects for more balanced growth in 1989 are not as bright as I'd like. The dollar's rise since the end of 1987 dampens the outlook for continued strong improvement in the trade balance. Investment spending also seems likely to slow. Moreover, I expect the personal saving rate to remain at its present low level through the end of next year. Finally, the federal budget deficit will remain massive, by even the most optimistic projections.

As I have stressed, the Fed's number one job is to promote price stability. We can't solve these structural imbalances in the economy, but we can and will resist the inflationary pressures they create.