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The Economy in 1989: A Need for Balance

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I am pleased to have the opportunity to share my views on the U.S. economy and economic policies with such a distinguished audience. As I see it, economic activity should slow in 1989 to a more comfortable and sustainable pace. The current expansion can continue for some time, provided we are able to keep inflationary pressures from getting out of hand.

I'll begin with a review of the economy's recent performance. Then, I'll talk about the stress points in the economy and the need for policy makers to strike a careful balance. Finally, I'll comment on the outlook for 1989 and 1990. But I plan to leave time for your questions and comments.

The U.S. Economy in Perspective

Turning first to the economy's recent performance, the current expansion is now in its seventh year -- a record for all peacetime expansions. In fact, this one is more than twice as old as the historical average. But just because it's old doesn't necessarily mean it's about to end. On the contrary, in 1988, more than 300,000 new (nonfarm payroll) jobs a month were created. And the pace of job creation has actually picked up so far this year, with an average of about 350,000 new jobs added in January and February. That brings the total number of new jobs created during this expansion to well over 19 million.

No wonder the civilian unemployment rate dropped to 5.1 percent in March. That's a 15-year low. Factories are humming along at nearly 85 percent of capacity -- the highest since the late 1970s. And the output of goods and services rose at a very strong 3 1/2 percent rate last year, if you ignore the effects of the drought. Finally, until very recently, inflation of consumer prices was averaging about 4 1/2 percent -- too high for the economy's long-run well-being, but well below the seven-percent average rate during the 1970s.

The Stress Points

All in all, this is hardly a picture of an expansion that is old and feeble. But there is cause for concern, because of ... the "D-words." "D" for deficits: the federal budget deficit that continues to hover around $150 billion; the private saving deficit, or shortfall, that's generated by an abysmally low private saving rate; and the foreign trade deficit that has improved in recent years, but remains huge.

The implications of these deficits are not encouraging. First, the U.S. is spending beyond its means and borrowing from abroad to do so. This, in turn, means that foreign investors hold a sizable lien on our future. And because we're not using the borrowed funds to invest in a major expansion of productive capacity, we're going to be forced to cut future living standards to pay off this debt.

As if those concerns are not bad enough, this "living beyond our means" also increases inflationary pressures. Warning signals have been flashing for some time now. For example, the very low unemployment rate and the high capacity utilization rate both suggest that the economy has been -- and still is -- operating at a level of activity that cannot be sustained without a pick up in inflation.

So, it's not surprising that virtually all the price indexes are giving up hard-fought ground now. In February, consumer prices were up nearly five percent, compared to their level a year ago. Producer prices were up even more -- nearly 5 1/2 percent over the same period. And February's big jump in producer prices followed on the heels of an equally large increase in January. Although this index is known for its volatility, these two jumps certainly alarmed financial markets.

But what really concerns me is the rise in underlying wage inflation. Wages and benefits rose at close to a five percent clip in 1988 (as measured by the Employment Cost Index), compared to around three percent in 1987. Recent experience tells me that once an inflationary spiral gets started here, it's really hard to root out. For instance, wage inflation still was <u>well</u> above four percent <u>two years</u> after the recession ended in 1982. In contrast, all the other inflation indexes had fallen more quickly.

How can we alleviate these stress points? A two-pronged attack is best. First, reduce the federal budget deficit. This would help us to live within our means and diminish our appetite for imported goods. It also would reduce our craving for foreign funds and produce lower interest rates. And, perhaps best of all (from my perspective), it would ease inflationary pressures.

The second prong of attack would be on the inflation front. This means a monetary policy that continues to resist inflationary pressures, but works in concert with deficit reduction. In fact, with a declining deficit, it might even be possible to fight inflation with <u>declining</u> interest rates! This two-pronged approach would help to ensure a steady reduction in the economy's stress points.

Unfortunately, there's not a lot of reason to be optimistic about the timeliness of the first line of attack. One obstacle is that the Congressional Budget Office and the Office of Management and Budget can't agree on how big the attack forces need to be. CBO is projecting deficits of $125 billion or more through 1993, while OMB expects a small <u>surplus</u> by '93. This incredible disparity arises because OMB envisions a considerably more rosy path for economic growth and interest rates than CBO does.

I believe that CBO's outlook will be closer to the mark. So, we need <u>big</u> cuts to reduce the deficit, even if the FSLIC crisis -- at a current price tag of $100 billion -- is left off the budget.

And because big cuts -- or big revenue increases -- are going to be hard to pull off, the Federal Reserve's battle will be more difficult. After all, the Fed can't do anything about the federal budget deficit or any of the other "D-words." Its task is to resist the inflationary pressures they foster. The Fed has done this over most of the past two years. Since March 1988, in particular, the Fed has tightened policy in gradual, but steady, steps. From a starting point of six percent in early 1988, we've raised the discount rate twice -- to seven percent, as of February 24th of this year. Likewise, short-term interest rates have risen about three percentage points over this period.

But resisting current inflationary pressures is not enough. The Fed's goal is to <u>eliminate</u> inflation over the long haul. As Chairman Greenspan indicated recently, inflation is too high if it's a factor in business and household planning. We're wasting precious resources if we have to use them to find ways to protect ourselves from the risk of price increases.

The Fed's goal of price stability is why it continues to reduce the target growth ranges for the broad monetary aggregates each year. For 1989, the Fed lowered both the upper and lower bounds of the growth range for our M2 measure of money by a full percentage point. The range is now three to seven percent.

Unfortunately, inflation doesn't give up ground quickly, as the latest producer price numbers attest. It takes about a year for a change in Fed policy to deal a measurable blow to inflation. So, the Fed's shift to a tighter policy last year should begin to produce results some time this year. And the effects of the Fed's most recent actions should be seen in 1990. Although these lags are frustrating, I think we're on the right track.

So far, financial markets seem to agree, even though the recent up tick in producer prices gave them a scare. Long-term interest rates have not risen by anywhere near as much as short-term rates. The widely-cited survey of financial decision makers by Drexel Burnham Lambert suggests that this flattening of the yield curve reflects a decline in long-run inflation expectations associated with the rise in short-term interest rates.

During past economic expansions, the Fed has been criticized for being a step or two slow in its counterattack on inflation. Inflation would tend to get out of hand, and only a serious economic contraction would bring it under control again. This time around, however, financial decision makers apparently believe that Fed action has been more timely. And I agree. We have a chance this time to curb inflation without an economic downturn.

<u>Looking Ahead</u>

But just what <u>is</u> needed to keep inflation under control? With the economy operating at, or even above, its long-run capacity to produce goods and services, we can't afford GNP growth even as high as the rate of growth in that capacity for the near term. It only makes sense.

In recent years, capacity probably has been growing at a rate of around 2 1/2 percent a year. We could quibble about this particular bench mark. But we'd be splitting hairs. The point is: if we want inflation to start yielding ground again, we've got to accept relatively slow economic growth. Moreover, slower growth for just a quarter or two probably won't be enough; reducing inflation significantly may take a prolonged period of growth at a pace below that of capacity.

Because of the snail's pace of progress on the federal budget deficit, slower economic growth is going to mean slower spending in the private sector.

Given this unpleasant tradeoff, some might ask, "what's wrong with a little inflation?" What's wrong is that a little inflation has a disturbing tendency to turn into a lot of inflation. As I see it, the choice boils down to this: either we pay the price to deal with it now, or we wait until it's a much stronger force that requires heavy artillery to stop.

If we are fortunate, past monetary restraint, including the Fed's most recent actions, may be enough to ease the economy into a more sustainable growth range. Even though the first quarter apparently was strong, that's not as worrisome as it might appear. Keep in mind that a whopping two and a half percentage points of the first quarter number will reflect the Commerce Department's adjustment for an assumed end of the drought. And for the remainder of this year, growth should be more moderate.

These are developments the Fed will have to watch carefully. Evidence that the economy is not slowing significantly would signal continued upward pressure on prices. On the other hand, we must be careful that the economy does not slow _too_ much. After all, recession comes with a high price tag, too. At the moment, the inflation risk definitely seems greater, but these opposing concerns do require a careful balancing act. And the Fed is mindful of this challenge.

Inflation Outlook

I expect inflation (as measured by the consumer price index) to rise at a faster clip this year than last year -- not that double-digit inflation is in the offing, but a rise from 4 1/4 percent last year to about five percent (Q4 over Q4) this year is quite likely. This forecast assumes that the drought moderates and agricultural production returns to more normal levels. If we get another year of drought -- a distinct possibility in some regions, at least -- inflation could be somewhat higher.

Also, if the dollar were to fall substantially, inflation could be considerably higher this year and next. A low dollar increases inflation by raising the price of imports and easing competitive pressure on domestic producers. Finally, the price of oil is another uncertainty in the inflation outlook -- if it does not fall from its present high levels, inflation will worsen.

Leaving aside movements in the dollar and food and energy prices -- factors that largely are beyond the control of the Fed, anyway -- my real concern is what's going to happen to underlying wage pressures this year and next. It is here that a slowdown in the pace of economic activity will have the most impact on inflation over the long haul.

As I see it, wage pressures are likely to remain strong this year, largely because the economy is operating at a high level. In coming months, I am hopeful that economic activity will slow somewhat. The Fed's recent actions should help in this regard. But we'll have to scrutinize the signals on the pace of growth to tell if the economy cools off enough. If it does, inflation should start to yield ground once again.

Implications for Oregon

You're probably wondering what this forecast implies for the Oregon economy. Basically, I think the economy here will slow as well, particularly since the State's lumber and wood products industries appear poised for a modest downturn. But the good news is that the slowdown will probably be less dramatic here than in the nation as a whole.

In the past year or so, this State has enjoyed heady, and long-overdue, economic growth. Moreover, the pattern of growth has been encouraging: because of phenomenal expansion in the trade and service sectors, and, to a lesser extent, in manufacturing, Oregon now has a much more diversified employment base than it did ten years ago. This should help the State weather a decline in forest product industry employment.

There is another factor that should help to buoy the Oregon economy: this State is an attractive place to live and work, because of its many physical amenities and its relatively low cost of living. At the same time, continued tightness in labor markets and plant capacity in other parts of the country make Oregon a good magnet for businesses seeking to expand.

Summary

In the final analysis, then, I think this year will end with the Oregon economy in good shape. But I'll be quick to add that recession in the U.S. as a whole is not likely, either. Certainly, I expect slower growth, but that's good news on the inflation front. And ultimately, that's good news for the longevity of our expansion.