FEDERAL RESERVE BANK
OF SAN FRANCISCO

OFFICE OF
THE PRESIDENT

1990 ECONOMIC OUTLOOK
(Speech Outline)

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The Economic Outlook and Policy Concerns in 1990

I. Today, what I'd like to do is discuss three topics:

   A. the recent performance of the U.S. economy,

   B. my thoughts on how economic developments might unfold this year,

   C. and finally, my concern about our economy's performance over the longer haul, with emphasis on the threat that inflation still poses.

II. With respect to the recent performance of economy, there's no doubt things have slowed down.

   A. Particularly in final quarter of last year.

      1. Employment growth slowed; retail sales (especially autos) weakened; and industrial production was flat.

      2. GNP estimate won't be available until end of next week, but I expect there wasn't much growth last quarter.

      3. This implies a growth rate (Q4-Q4) for 1989 as a whole just under two percent (adjusted for drought).

   B. This is in sharp contrast to 1988 and 1987 when growth averaged close to 4 3/4 percent a year (after adjusting for drought).

C. Question is, does slowdown in fourth quarter signal a recession in 1990?

1. My answer is no. Most other forecasters appear to agree.

2. For one thing, U.S. economy still is on solid footing.

   a. Business spending on plant and equipment has been strong in recent years.

      (1) This adds to productive capacity and provides basis for continued growth.

   b. Net exports also have shown surprising strength, despite relatively high dollar.

3. Moreover, slowdown late last year due largely to temporary factors.

   a. Adjustment in auto industry;

   b. Boeing strike (Q4 output loss estimated at $9 billion AR, or about 1% decline at AR);

   c. San Francisco earthquake; and

   d. recent cold snap, particularly in East.

4. As things return to more normal patterns, economic growth should rebound this quarter and next.

a. In fact, reconstruction in Charleston area following Hurricane Hugo and reconstruction in Bay Area should provide extra stimulus to growth for a time.

III. So, as I look out over the next year, I think we have a good chance of avoiding a downturn.

A. For 1990 as a whole, I expect real GNP to rise by around 2 percent.

1. Strength to come from consumers in response to past strength in disposable income.

2. Important boost will come from increased housing investment.

3. Business spending on plant and equipment, though not as strong as in recent years, should remain moderate at least.

B. Big issue in forecast is what we assume about dollar.

1. If we assume dollar remains at current level, expect some weakness in net exports.

a. But moderate growth in other sectors should help to offset this weakness.

2. What actually happens to the dollar is important because changes in the dollar affect both real GNP and prices.

a. For example, a decline in the dollar would tend to boost the economy and inflation this year.

3. For this reason, Fed must be flexible enough to take the dollar into account in formulating policy.

a. A decline in dollar, for example, would require slower growth in monetary aggregates and higher interest rates than would be the case if the dollar rose.

C. In sum, I expect to see moderate economic growth in 1990, but not a recession. Thus, economy this year should be able to extend its long-running economic expansion into its ninth year.

IV. But I do have a longer-term concern I want to share with you.

A. Even though economy has slowed over past year, inflation risks remain.

B. The economy still is operating at a level that strains capacity and generates inflationary pressures.

1. In particular, level of the unemployment rate likely to remain below level most economists consider consistent with keeping inflation under control.

2. As long as this situation continues, pressure in labor markets will put upward pressure on wages and in turn, on prices.

3. Aim of Fed policy has been to ease inflationary pressures gradually by slowing growth to somewhat

below rate of growth in capacity;

4. Problem is, it takes 12 to 18 months for effect of policy to be evident in economic activity and inflation.

    a. That's like waiting a year to get medical test results when decisions regarding treatment must be made now.

C. To get an idea of what the future holds, I look at a measure of "underlying inflation."

1. that's what you get when you take out the effects of movements in the dollar and the prices of energy and food.

2. Underlying inflation is still quite strong.

    a. Currently, this measure is running between 4 1/2 and 5% a year.

    b. Underlying inflation, moreover, is about 1/2 of a percent higher than it was at the beginning of last year.

D. So, here's my inflation outlook:

1. If economy expands at the moderate pace I expect, inflation should come in at about the same rate as last year.

    a. around 4 3/4 percent for CPI.

2. But I don't expect inflation to begin moderating until the unemployment rate inches up and economic activity backs away from levels that strain capacity.

3. The bottom line is that inflation still is, and will continue to be a problem.

E. This leads me to conclude that Fed must perform careful balancing act.

1. Avoid undue risks of recession.

2. But also reduce inflationary pressures.

F. There are a number of reasons it's essential that we do something to bring inflation down.

1. First, inflation produces a string of undesirable effects on economy.

a. It arbitrarily transfers wealth, leading to costly and unproductive attempts to hedge against inflation.

b. It tends to reduce capital investment by raising risk premia in long-term bond yields.

c. Finally, it's bad because it distorts price signals, making business and household planning more difficult.

2. The second reason inflation needs to come down is that even a little inflation has a tendency to turn into a lot of inflation.

a. Once inflationary spiral gets started, it's costly to root out.

b. I don't want to repeat the experience of the late seventies and early eighties. I suspect you don't either.

3. I'm encouraged Congress recognizes that inflation is bad for the long-run health of the economy. I strongly favor the proposed Neal Resolution, which calls for bringing inflation down to zero percent over a five-year period.

4. I believe this is a goal that can be met.

G. But we've got to be willing to accept slowdown in growth for some time.

H. The long-run benefits -- increased investment, better household and business decisions, and enhanced productivity -- are worth the cost.