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The Economic Outlook and Policy Concerns in 1990

I. As a Lamorinda resident myself, I'm especially pleased to be here today, talking to you as a friend and neighbor. 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 are unfolding 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 slowed down last year.

A. Particularly in the final quarter, which registered growth of only slightly above one percent.

B. As a result, growth (Q4-Q4) for 1989 as a whole barely topped two percent (adjusted for the drought).

C. This is in sharp contrast to 1988 when growth averaged 4 percent (after adjusting for drought).

D. As it turned out, slowdown late last year was due largely to temporary factors:

1. Adjustment in auto industry;

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

3. San Francisco earthquake; and

4. Cold weather, particularly in East.

E. Since then, things have returned to more normal patterns, and economic growth has rebounded.

1. GNP data for the first quarter were released this morning.

2. They show economy growing at a __ percent annual rate.

F. Clearly, this is still much slower than the heady pace in '88. But the question is, does this slowdown signal a recession in 1990?

1. My answer is no.

   a. In fact, as I look out over the remainder of this year, I think the chances of a downturn are relatively small.

   b. 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.

   b. This adds to productive capacity and provides basis for continued growth.

   c. And although business investment probably won't be as strong this year as in recent years, it should remain moderate at least.

3. Second, because household disposable income has been rising steadily in recent years, consumer spending has been robust.

   a. Moreover, these past gains in income mean that consumer spending should provide continued strength through 1990.

4. A final reason I think recession risks are low is that exports continue to show surprising strength, despite relatively high dollar.

   a. The booming growth of our trading partners is playing a major role in this regard.

G. Putting all these observations together, then, I expect real GNP to rise by around 2 ¼ percent for 1990 as a whole.

III. However, a big issue in outlook is what's going to happen to the dollar.

A. The behavior of the dollar is important because changes in its value affect both real GNP and prices.

1. For example, a decline in the dollar would tend to make our goods more competitive abroad and foreign goods less competitive in the U.S. This would boost our economy this year and next.

2. A lower dollar also would raise inflation temporarily, by raising the prices of imported goods purchased in this country.

3. A *rise* in the dollar, on the other hand, would have just the opposite effects on inflation and U.S. output.

B. Clearly, Fed must be flexible enough to take the dollar into account in formulating policy.

1. A decline in the dollar, for example, would require slower growth in monetary aggregates and higher interest rates than would be the case if the dollar were to rise or remain at its current level.

C. In light of these considerations, it's obvious that the dollar's behavior is going to have an important impact on the strength of the economy in 1990.

1. Unfortunately, fast-breaking developments around the world are making it even harder than usual to interpret the dollar's movements.

a. On the one hand, a rise in inflation abroad, including Japan and Germany, has put upward pressure on the dollar.

b. Likewise, political uncertainties and problems in the stock market in Japan probably are contributing to the dollar's rise against the yen.

c. On the other hand, however, the market's expectation of higher demand for credit from Eastern Europe, especially East Germany, has raised real interest rates abroad and put *downward* pressure on the dollar.

2. For the moment, these developments appear to have had offsetting effects on the dollar.

3. What this means is that if we assume the dollar remains at current levels for the remainder of the year, we'll probably see less improvement in net exports this year than in recent years.

4. As I've noted, though, consumer sector should remain robust, and this should offset the slowdown in net exports.

D. In sum, then, I expect to see moderate economic growth in 1990, but not a recession. I believe the economy this year can and will 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 the economy has slowed over past the year, inflation risks remain.

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

1. In particular, the unemployment rate is likely to remain below the 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 quite strong.

    a. Currently, this measure is running around 4½ percent a year.

    b. Underlying inflation, moreover, is about ½ 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 somewhat higher than last year.

    a. CPI inflation came in at a disturbingly high 7½ percent in the first quarter, even after removing increases in food and energy prices. I do not expect this torrid pace to continue, but nevertheless, it seems likely that the CPI will rise by around 5 percent for this year as a whole.

2. And I don't expect inflation to begin moderating very quickly.

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

V. This leads me to conclude that the balance of risks has shifted somewhat more toward inflation.

A. Although the Fed must avoid increasing the risks of recession unduly,

B. we also must be sure to guard against a further rise in inflationary pressures.

C. 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 distorts price signals, making business and household planning more difficult.

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

a. As you know, we've enjoyed relatively modest inflation for some time now. So, it's easy to forget how painful inflation can be.

b. But in the current environment, failure to keep a steady hand on the throttle could mean costly damage-control later on.

3. I prefer an approach that gradually but steadily whittles away at inflation. And I suspect you do, too.

D. But this means that we've got to be willing to accept slowdown in growth for some time.

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