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**The U.S. Economy in the New Year:
Prospects and Policy Issues**

I. Today, I'd like to give you my views on prospects for the U.S. economy over the next year or so.

   A. With the geo-political upheaval in the world, this is a particularly difficult time to forecast.

      1. My version of the outlook is only a best guess in a very uncertain time.

   B. In view of recent **economic** news, it's easy to be pessimistic about the U.S. economy. However, we see not only the sources of pessimism, but also some reasons for optimism.

   C. In my remarks today, I'll touch on some major uncertainties that will help determine whether an optimistic or pessimistic scenario develops, and on how this uncertainty affects monetary policy.

II. To put our current economic situation in perspective, it's useful to recall that from 1982 to '89, economic growth was vigorous -- averaging 3½ percent a year.

   A. But since the beginning of 1989 the economy has slowed substantially.

   B. Last quarter, the sluggish growth turned into an outright contraction. And it now is likely that this decline will last long enough to qualify as a recession.

      1. Weakness has shown up in nearly every sector of the economy, including consumer spending, business investment, and housing.

III. With the downturn being felt in many areas, it's not surprising that a number of possible causes have been proposed. I'll say a few words about some major candidates.

   A. First, the credit crunch. Frankly, I suspect that tighter credit standards by banks are having only a modest effect on overall economic activity.

      1. Research at the San Francisco Fed does suggest that bank lending nationwide has been somewhat

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lower than would normally be observed at this stage of the business cycle, although this development has not been evident in the 12th District.

2. However, many borrowers have other sources of credit, so the independent effect of tighter credit standards at banks probably is not very great.

B. Higher oil prices have contributed to current economic problems, although I doubt they are a full explanation.

1. There's no telling how long Iraqi and Kuwaiti oil supplies will be off the world market, but alternative sources of oil appear to be ample at the present time.

2. If there is a prolonged war, we could be in for a long bout of higher oil prices, which could seriously stunt economic growth in the U.S. and abroad, and raise inflation for a time.

3. However, based upon analysis of the much larger oil shocks in the 1970s, the oil price hikes we've seen to date are **not** big enough to explain the degree of weakness currently evident in the economy.

C. The final factor I'd like to mention is sagging consumer confidence.

1. Two major surveys show very large declines in consumer confidence in recent months. In fact, the Conference Board's index registered the largest drop in its 22-year history in October; and the level has not changed much for either November or December.

2. Consumers certainly have a number of good reasons to be pessimistic--in addition to the oil shock and the political uncertainties in the Middle East, well-publicized problems in the thrift and banking industries, and doubts about prospects for reducing the budget deficit are serious enough to create low levels of confidence.

3. Such attitudes may go a long way toward accounting for the unusual weakness we've seen recently in consumer spending -- particularly on "big ticket" items, such as autos and housing.

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IV. As I mentioned at the outset, there are some rays of hope in today's generally gloomy economic environment.

   A. The steep drop in the dollar since mid-89 should give a substantial boost to our economy.

      1. A lower dollar makes our exports more attractive, and should help to improve our trade balance.

      2. Growth in most of our major trading partners has been more rapid than here, giving an added impetus to demand for our products abroad.

         a. However, that demand could be dampened if the oil shock and tight monetary policy in some countries slow growth abroad.

   B. Second, inventories now are at relatively low levels, especially in the manufacturing sector.

      1. This is good news. If inventories were high, then we'd expect significant further production cut-backs, a typical scenario that has intensified most other downturns.

   C. Last, Fed policy has become more accommodative.

      1. Since July, short-term rates have dropped one and a half percentage points.

      2. This decline in rates should begin to boost the monetary aggregates and add strength to economic activity in the next few months.

   D. Thus, weighing the pluses and minuses, my best guess is that we'll see a modest rebound in the latter half of this year.

      1. But, given the war in the Middle East, we must be prepared for a wide range of developments.

      2. A quick resolution of the conflict probably would boost real GNP growth in the U.S. through improved consumer confidence and lower oil prices.

      3. The effects of a prolonged conflict on U.S. economic activity are more difficult to gauge.

         a. High oil prices and uncertainty of consumers and businesses could reduce real GNP.

V. Let me turn now to inflation.

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A. As I mentioned at the outset, there are signs that bode well for inflation later this year and beyond.

   1. For example, some market indicators of inflation have begun to look positive.

      a. Commodity prices are down from their peak in the middle of last year.

      b. Long-term interest rates now are substantially lower than in September, perhaps suggesting an easing of inflation expectations, as well as softness in the economy.

   2. More importantly, the inflationary effects of the oil shock are beginning to dissipate.

      a. The annual consumer inflation rate, which had jumped to 9 percent between August and October, dropped back to 3½ percent in November and December.

      b. Of course, at this point we cannot rule out a prolonged war that could raise oil prices again and undermine progress against inflation. But assuming the war is fairly short, the worst effects of the oil shock may be behind us.

   3. Finally, there are signs that underlying inflation has peaked, and may even be on a slightly downward trend.

      a. The latest figures show some slowing in the growth of wages, salaries, and benefits.
      b. This may reflect the recent slackening that has developed in labor markets, as the unemployment rate has risen by about ¾ percent since early 1990.

      c. Although the lower dollar is raising the cost of our imports and temporarily pushing up prices, improvements in underlying inflation should be felt by year-end.

VI. Of course, I'm not going to comment on any current policy issues related to the war. Instead, I will discuss issues concerning monetary policy and the recession which is still with us.

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A. Maintaining sustainable economic growth **is** one of the Fed's most important concerns, and we have responded in recent months to the wide-spread signs of weakness in the economy.

   1. The series of moves since July to lower interest rates should help to prevent a prolonged downturn.

B. At the same time, we've got to be careful in responding to today's weak economic numbers.

   1. Since monetary policy affects the economy with a considerable lag, today's actions to offset current weakness will be felt mainly after mid-year, when the economy already may be picking up for the reasons I have outlined.

   2. We don't want to over-react to the downturn, and thereby lose or even reverse hard- won gains on underlying inflation.

VII. The problem of dealing with lags is illustrated by comparing the recent and prospective behavior of an important policy indicator--nominal income.

A. We estimate that nominal income grew by only 4¼ percent in 1990.

   1. With inflation estimated at about the same rate, real GNP showed little or no growth last year.

   2. And, if nominal income were to continue at such a slow pace in 1991, we most likely would experience another year of little or no economic growth.

B. Depending on what happens in the Middle East, my best guess is that nominal income will pick up in 1991 -- to a growth rate of about 6 percent. This pace would be enough to permit moderate real GNP growth.

C. In addition to the effects of robust exports, nominal income will be boosted by the lagged effects of the easing of monetary policy since July.

   1. We estimate that the decline in interest rates since then is likely to add about 1 to 1¼ percent to nominal income growth this year.

   2. I also might add that the same pattern of movements is likely to show up in the monetary aggregates. Although they have been quite weak, the decline in interest rates we have already seen

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should stimulate an acceleration in money growth this year.

D. These observations illustrate the dangers inherent in basing policy actions **solely** on current economic developments, and show why it is critical to consider the effects of earlier actions on future developments.

   1. Although the economy is weak now, actions already taken should produce a reasonable bounce-back in spending. Moreover, a quick resolution of the war, should that occur, also could contribute to a rebound in the economy.

VIII. While bearing in mind that further substantial easing of policy might <u>over</u>stimulate the economy later this year, I do not want to put too much emphasis on the point. For obvious reasons, forecasts are unusually uncertain at the present time.

A. In view of this, single-minded attention to forecasts would not be prudent. Policy also must not ignore concerns about current weakness in the economy.

B. Thus the present environment requires that the Fed do a delicate balancing act: guarding against the risk of a prolonged downturn, while maintaining a longer-term perspective, so that we do not lose sight of our ultimate goal of eliminating inflation.

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