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A POLICYMAKER'S PERSPECTIVE ON THE U.S. ECONOMY

I. Thank you. I'm delighted to be here today.

A. As I was preparing for this talk, I was very interested to see the report on the economic literacy survey done by the National Council on Economic Education.

1. I'm sure many of you have seen it, too.

B. The results were pretty striking:

1. The respondents—who were adults and high school and college seniors—tended to get the right answers only 40 percent of the time!

C. Now, some people would explain these results simply by saying that people don't know about economics because it's *dull*. It's even been called "the dismal science."

1. And we economists are somewhat at fault here, because we've wrapped a lot of our thinking in jargon and statistics that seem impenetrable.

D. But the heart of economics isn't numbers, it's people—how people make choices every day to further their well-being.

1. And a knowledge of economics can help people make more *informed* choices,

2. because they'll have a better grip on the real costs and benefits, the real risks and returns.

E. A good example is this year of presidential campaigns, with candidates flinging numbers and proposals at us.

F. With so many choices before us, it's especially important to know something about what it all means—to be able to evaluate for ourselves whether the numbers and proposals make sense.

G. Well, today, I'm going to address some issues about the economy.

1. I'll be discussing how monetary policy works, how the foreign exchange crisis affects us, and what the goals of monetary policy are.

2. These all pertain, of course, to the outlook for the economy,

    a. that is, what kind of growth and what kind of inflation we're likely to see over the next year or so.

II. Let me begin with the obvious. As you know, the national economy's performance hasn't been anything to cheer about.

A. The last three years have been one of the longest periods of slow growth in this country's postwar history.

B. And though we're technically out of the recession, the recovery is sluggish.

1. According to data for the spring quarter—the most current complete data available—real GDP grew at only a 1½ percent rate.

2. Moreover, partial data for the third quarter suggest a continuation of the sluggish pace.

III. Arizona has actually fared better than many other parts of the country during this cycle.

A. While employment nationally is about 1½ percent lower than it was a couple of years ago,

1. the number of jobs in Arizona has actually *grown* 1½ percent.

B. One reason is the timing of the U.S. and Arizona construction cycles.

1. The last couple of years have been very difficult ones for the construction industry nationally.

2. But for Arizona, the bleak years were earlier.

    a. In the late 1980s, the contraction in Arizona's consturction industry was huge.

3. Since then, things have been picking up in construction, at least on the residential side.

    a. In fact, I even understand that here in Tucson you're going through something of a residential building boom.

C. Still, the state has been affected by the slowness in the national economy.

    1. For one thing, the rate of job creation in Arizona is about a third of what it was in the middle of 1990.

D. And a couple of sectors are actually doing worse in Arizona than they are nationally.

    1. For example, manufacturing employment has fallen 10 percent during the past two years, compared with a 5 percent decline nationally.

        a. This decline is largely due to defense cutbacks.

    2. In addition, financial industries also are hurting.

        a. The real estate problems of a few years ago haven't worked their way through the financial system, so the profits of Arizona banks remain low.

IV. Now let me turn to the national picture.

A. In order to revitalize the economy, the Fed has eased monetary policy substantially.

    1. The federal funds rate and other short-term rates are now about a third of what they were in early 1989.

    2. The discount rate now stands at 3 percent, its lowest level in nearly three decades.

B. This easing works to stimulate spending on goods and services, and therefore economic activity.

    1. First of all, lower interest rates boost spending on business equipment and consumer durables, like autos, furniture, and appliances.

    2. We've also seen the effects of dramatically lower rates on the housing market.

a. Residential investment has grown at an average rate of more than 12 percent for nearly a year and a half, with most of the increases in single-family units.

b. Although housing activity slowed a few months ago, we got good news on housing starts for August, and I expect to see fairly strong figures in the year ahead.

3. Finally, lower U.S. interest rates tend to lower the foreign exchange value of the dollar.

a. This boosts our economy for two reasons:

(1) it leads buyers here at home to shift from imported to U.S.-produced goods,

(2) and it stimulates foreign demand for our products.

V. But lately, the turmoil in the foreign exchange markets has moved the dollar around a lot. So naturally, we want to know what effect this turmoil has on our economy. Does it magnify the effects of our lower interest rates, or does it nullify them?

A. As you know, in recent years, several European countries have pegged their currencies to the German Mark.

1. In effect, this means that they coordinate their monetary policies.

B. Over the last year or so, Germany has been concerned about the inflationary effects of the costs of reunification,

1. so they've followed a tight monetary policy with high interest rates.

C. But a tight monetary policy was a hard pill to swallow for a number of other European countries that have been facing slow growth or outright recession during this period.

1. For example, the U.K. has been in recession since the middle of 1990, with unemployment at almost 10 percent as of August.

D. So, in September, as conditions worsened, the U.K. decided to let the pound float, and Italy and Spain devalued their currencies.

1. In other words they've let their interest rates and currencies fall.

E. What's the effect of these developments on our economy?

1. Easier monetary policy in those countries should help to cushion their economic declines.

a. However, the policy actions taken so far don't seem to be big enough to offset fully the weakening trends in their economies.

b. This is *not* good news for U.S. exports.

2. In addition, declines in the currencies of these countries mean that our exports are more expensive, which should further weaken their demand for our products.

F. Overall, then, developments in Europe may have offset part of the positive effect of lower U.S. interest rates.

VI. This is one reason that the present low-interest-rate environment in the U.S. is likely to produce only a modest expansion.

A. There are other reasons as well.

1. We've been importing foreign goods, especially computers, at a rapid pace in recent years, and we expect this trend to continue.

a. This cuts into demand for domestically produced goods and services.

2. Then there's fiscal policy.

a. In view of large federal budget deficits and the end of the cold war, the government has cut back spending, especially for defense.

3. Finally, I don't need to tell you that there's trouble in the commercial real estate market.

a. Normally, lower interest rates tend to stimulate spending on commercial real estate.

b. In fact, this is one of the channels monetary policymakers traditionally rely on to pull the economy out of a recession.

c. But, because of the overbuilt market and the resulting high vacancy rates we have now, it's unlikely that this channel will work the way it has in the past.

VII. Now, let me give you my outlook for inflation.

A. During the past three years of recession and slow growth, labor and product markets slackened, and this restrained growth in labor compensation and product prices.

B. Moreover, since the pick-up in the economy will probably be gradual over the next year or so, we're likely to see continued downward pressure on inflation.

1. So far this year, core consumer inflation -- which excludes the volatile food and energy component from the consumer price index -- has risen at around a 3½ percent rate, and I expect to see it decline to about 2½ percent for this year as a whole and in 1993.

2. Compared to the 4½ percent core rate of consumer inflation in 1991, 2½ percent definitely would represent progress.

VIII. This downward trend in inflation is in keeping with the Federal Reserve's main long-term goal of moving gradually toward price stability—a crucial element to achieving maximum economic growth in the long run.

A. Our progress on this front in recent years is important because it gives us greater latitude to respond to weakness in the economy if it's necessary.

B. Given our recent persistent sluggish economic performance and our expectations of only a modest expansion, we can't rule out the possibility that further stimulative action will be needed.

C. But I want to emphasize that while we're doing what we can to help sustain economic recovery,

1. we're also being careful to preserve and advance hard-won gains against inflation.

D. I think our efforts in both areas ultimately will pay off.

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