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U.S. ECONOMIC PROSPECTS IN 1993: A POLICYMAKER'S PERSPECTIVE

I. Thank you. I'm very pleased to be participating in the conference this year.

   A. My comments today focus on the outlook for the U.S. economy.

   B. And, to put it briefly, I'd say the outlook is good--but there are some areas that will bear watching.

      1. In terms of the overall economy, it looks like the expansion is firmly in place.

         a. But there are still a number of factors that will likely keep it to a fairly moderate pace.

      And on the inflation front, the fundamentals look favorable.

         a. But some high inflation numbers early in the year suggest that we can't take anything for granted, and will need to monitor future data on inflation very carefully.

II. Let me begin with a very brief review of recent developments.

   A. After nearly three years of recession and sluggish growth, a pattern of moderate expansion took hold in the first half of 1992, when real GDP grew at a 2¼ percent rate.

      1. Then, in the second half of the year, economic growth accelerated further.

         a. In fact, the economy expanded in the fourth quarter alone at a strong 4.7 percent rate!

      2. Data released this morning show that the economy slowed in the first quarter of this year.

         a. However, part of the slower growth is weather-related, and it appears that the expansion is still well in hand.

B. In my view, monetary policy can take some of the credit for this expansion.

1. Since economic growth turned sluggish about four years ago, the Fed has eased monetary policy substantially.

a. These actions have brought down the federal funds rate and other short-term rates to about a third of what they were in early 1989,

b. and have helped to bring down long-term interest rates as well.

C. Of course, some people would disagree with this assessment, and say that policy has been too tight.

1. And for evidence they'd point to the behavior of the broad monetary aggregates—M2 and M3—over the past few years.

a. In 1991 M2 and M3 bumped along toward the bottom of their ranges.

b. In 1992, and so far in 1993, they've actually been below their lower boundaries.

D. In my view, these developments don't reflect a policy that's too tight.

1. Instead, they reflect instability in the velocity of these aggregates.

2. Three main factors—the steep yield curve, weak loan demand, and high rates on consumer loans—seem to account for this instability.

a. First, the unusually steep yield curve in recent years seems to have induced substitution out of instruments in M2, like CDs, and into stock and bond mutual funds.

b. Second, weak bank loan demand and the downsizing of the thrift industry have led depository institutions to bid less aggressively for funds, mainly through large CDs, but also through small time deposits.

c. Finally, high interest rates on bank and thrift loans to consumers have induced them to use M2 balances to pay down loans.

3. These developments have distorted the historical relationship between spending on goods and services and the quantity of M2 balances that the public wishes to hold.

E. Moreover, they are specific examples of a general problem with M2 growth as an indicator of future economic activity, a problem that seems unlikely to go away any time soon.

   1. Since the early 1980s, deregulation and technological change in the financial industry have led to more and more substitutability for instruments in M2.

      a. The number of instruments has increased, and the transactions costs of switching between them has fallen.

   2. This new environment means that small changes in yield spreads and other incentives, like risk, for example, can lead to fairly large portfolio re-allocations into and out of M2.

   3. Developments like these don't have a major impact on the pace of economic activity,

      a. and it would be a mistake for policy to react to them.

   4. The problem is that at any particular time it's difficult to tell if movements in M2 simply reflect portfolio reallocation or if they're telling us something about the future of the economy.

      a. That's why we closely monitor and analyze developments in the aggregates—to try to separate out the "noise" so that we can properly interpret the underlying "signal".

   5. The events of the past year are a good case in point.

      a. The fact that the economy established an expansion phase in 1992 confirms that policy has been about on course, despite very slow M2 growth.

III. As I look ahead to the remainder of 1993,

A. I expect interest-sensitive sectors of the economy to lead the continuing expansion.

    1. These sectors–business investment in equipment and consumer spending on housing and other durable goods–expanded rapidly last year, and are likely to do so again in 1993.

B. But there are a number of reasons to believe that developments in other parts of the economy will hold the expansion to a moderate pace.

    1. First, a number of our most important industrialized trading partners are going through slowdowns themselves,

        a. and this will tend to hold back the volume of U.S. products we can sell abroad.

        b. The recent easing of monetary policies in much of Europe and of both monetary and fiscal policies in Japan will help, but I still expect to see weak growth abroad this year.

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

        a. This cuts into demand for domestic products.

    3. Then, there's trouble in the commercial real estate market in a number of places.

        a. The vacancy rate nationally is high, at almost 19 percent.

        b. And it will probably take years to work off this much overhang.

    4. Finally, the large budget deficit and the end of the cold war have led the federal government to cut back, especially for defense.

        a. And state and local governments, too, have been constrained in the face of their own deficits.

        b. Of course, the outlook may change once we know how negotiations on Clinton's budget proposal work out.

(1) The Administration's failure on the temporary spending program will have only a very small negative effect on economic growth this year and next.

C. So, all in all,

1. I look for growth to be in the neighborhood of 3 percent, rather than the 4 to 5 percent that would be normal at this stage of a business cycle expansion.

2. As a result, the unemployment rate will decline only gradually.

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

A. Over the period of recession and slow growth, labor and product markets slackened, and this restrained growth in labor compensation and product prices.

1. Since the economy probably will grow only moderately this year, these pressures for disinflation are likely to continue.

2. Another factor contributing to the disinflationary trend is the large increase in worker productivity in 1992

a. —the largest of any year in the last two decades.

b. If this continues, firms will have a better chance of meeting increased demand without having to increase prices.

B. Despite these favorable fundamentals, we did get some worrisome inflation numbers in January and February.

1. Core consumer inflation—which excludes the volatile food and energy component from the consumer price index—rose at a 6 percent annual rate in both months.

2. Although it dropped in March to only a little over 1 percent,

3. this still left the average inflation rate for the first quarter as a whole at a relatively high 4¼ percent.

4. Furthermore, employment costs also rose at a

faster pace in the first quarter.

C. It's too soon to tell if these recent data represent a trend or an aberration.

   1. But for now, I expect to see core inflation decline somewhat this year and next from the 3½ percent rate registered in 1992.

   2. However, future inflation figures will warrant careful attention to see if they reverse the strong increases early this year, or if inflation is turning out to be more of a problem than now seems likely.

V. What does this mean for monetary policy?

A. The main way the Federal Reserve can contribute to long-run economic growth is by providing an environment of low inflation.

   1. So the downward trend in inflation that seems to be in place would be in keeping with that long-term goal.

   2. However, we can't rule out the possibility that the first quarter inflation figures are a danger signal,

      a. especially now that the expansion seems to have been established.

   3. Therefore, the situation should be watched carefully.

B. I want to emphasize that while we'll pursue policies consistent with the continuation of the economic expansion,

   1. we also must be careful to preserve and advance hard-won gains against inflation.

C. I think our efforts in both areas will pay off.

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