Community Leaders Luncheon
Boise, Idaho

For delivery September 9, 1993

I. I'm delighted to be here in Boise. Today I'm going to give you my views on the U.S. economy.

II. But let me start with a quick look at economic conditions in the Twelfth Federal Reserve District and here in Boise.

   A. In fact, I'd like to start with the Boise area because the economic picture here is so good, especially compared to some other areas in the District.

      1. Payroll employment is 5½ percent higher than a year ago,

      2. manufacturing is booming,

      3. and although employment growth in construction and mining has slowed from last year, these sectors are still growing at a nice clip.

   B. In the rest of the District states, conditions are not nearly this strong, except for Utah.

      1. For example, troubles in the forest products industry are taking a toll both on Oregon and Washington.

      2. And Washington's problems are compounded by cutbacks at Boeing.

   C. Finally, California is still in its longest and deepest recession since World War II.

      1. The problems are broad-based, and affect a wide range of manufacturing industries, retail trade, services, and state and local governments.

      2. While there's some evidence that the worst of the state's downturn may be past, it's unlikely that we'll see robust growth in California any time soon.

         a. Further defense cuts, overbuilt commercial real estate markets, and persistent fiscal problems will continue to be a drag on California's economy during the next few years.

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III. Now let me turn to the national picture.

A. If we focus on what's ahead in the short run, three major factors dominate the scene:

1. the government's fiscal policy

2. conditions in the global economy,

3. and finally, our own monetary policy.

B. In the short run,

1. the first two forces—fiscal policy and the weakness in most of our major trading partners—are having *contractionary* effects on the economy.

2. Counterbalancing these contractionary forces is monetary policy, which has cut short-term interest rates substantially—if cautiously—in the past few years.

3. Taken altogether, this adds up to

a. moderate real GDP growth of between 2½ to 3 percent through the end of next year,

b. small reductions in the unemployment rate,

c. and some modest reductions in inflation.

C. This short run picture isn't what's considered "normal" following earlier recessions.

1. For example, in the two years after the trough of the the last five recessions, output grew on average by around 10 percent.

2. But two years after the 1991 recession, output had grown by only about 5 percent.

D. If we take a longer view, though, we'll see that the current situation isn't "normal" because we're actually in a period of transition.

1. The adjustments being made today in fiscal policy and in monetary policies here and abroad are setting the stage for a healthier economic environment in the future.

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IV. Let me begin by looking at fiscal policy and the effects of the new budget.

A. We've seen cutbacks at all levels of government for a while now, both because of deep cuts in defense and because of budget deficits at all levels of government.

B. As I'm sure you know, the new budget promises even more.

1. Spending cuts and higher taxes will weaken demand and have some direct contractionary effect.

C. Of course, the aim of the new budget is to reduce the deficit. And that will be good for long-run growth.

1. The government will absorb less private saving.

2. So more of it will be available for private capital formation, which is key to long-term growth.

D. According to estimates from the Congressional Budget Office,

1. the budget plan will knock about $50 billion off what the deficit would have been in 1994

2. and cumulatively about $500 billion over the next five years.

E. So long as Congress and the Administration follow through, it looks like it will trim the deficit.

1. And surprisingly, it manages to do so by balancing the tax increases with roughly equal spending cuts.

F. Now, I certainly could argue over some of the provisions.

1. For example, I would have preferred more emphasis on spending cuts and on consumption taxes rather than income taxes.

2. Furthermore, some of the scheduled cuts in federal health costs may not all come through—depending on what's in the health care plan.

3. But I *do* think overall this budget plan *does* represent a serious attempt at deficit reduction.

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G. And it looks as if the markets share that opinion.

1. Long-term interest rates are down,

2. and that will at least partially offset the contractionary effects of the budget.

V. Now let me turn to the contractionary effects of the weak economies of our trading partners.

A. For a couple of years now, economic activity among our major trading partners has been lackluster, or worse.

1. If we look at the other G-7 countries—Canada, France, Germany, Italy, the UK, and Japan—we see that

a. collectively, their output expanded by only 1-1/2 percent in 1991, and by only 1/4 percent in 1992.

B. What's going on? Well, for different reasons, both Japan and Germany have been following fairly tight monetary policies, especially in the last few years.

C. First, Japan:

1. After years of strong expansion and phenomenal growth in asset values, in 1989, the central bank put on the brakes to head off inflation.

2. The result was a collapse in money growth, which led to a big dive in asset values and sent the economy into recession.

D. In Germany,

1. the high costs of reunification begun in 1990 created inflationary pressures,

2. and the central bank has been insistent about keeping inflation under control.

3. The result is that in the past year, the German economy has been in a recession.

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E. The downturn in Germany also led to slow growth or recession in some of the other members of the European Community—largely because the European Exchange Rate Mechanism committed them to following Germany's low-inflation policy.

1. But for some countries, the tight policies were far *too* tight, and so, as you know, we saw more than one exchange rate crisis in the Europe over the past year.

F. These crises have weakened the Exchange Rate Mechanism,

1. but they haven't weakened the commitment to maintaining low-inflation policies for EC member countries.

G. Why the emphasis on low inflation? The reason, I think, is that there's widespread recognition that high inflation doesn't make economic problems better--it makes them worse.

1. The gains from inflation are temporary, at best.

2. And the costs can be very high.

a. For one thing, high inflation often is associated with high uncertainty about *future* inflation.

b. And more uncertainty hinders the long-run growth potential of the economy

(1) by fostering higher long-term real interest rates

(2) and by complicating the planning and contracting by business that is so essential to capital formation.

c. High inflation also hinders economic growth

(1) by heightening the distortionary effects of most tax systems,

(2) and by driving people to wasteful inflation-hedging activities.

H. So, even though it's a hard pill to swallow, *most* developed countries have tried to reduce their inflation rates in recent years in order to reap the benefits of stronger economic growth in the long run.

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VI. Finally we come to US monetary policy, which has worked to offset the negative effects of our fiscal policy and slow growth abroad, while continuing to make progress on the inflation front.

A. Since the economy turned sluggish about four years ago, the Fed has lowered short-term interest rates substantially—

1. to about a third of what they were in early 1989.

2. That's helped bring down long-term rates—to a record low in the case of 30-year Treasuries.

B. Though the drop in rates has been substantial, the Fed has proceeded cautiously.

1. First, we're concerned about the message we send to financial markets.

a. If we move too rapidly, markets would worry about a possible rise in inflation, which would raise long-term interest rates and harm the recovery.

2. Second, we have the same concerns about inflation that Japan, Germany, and the other EC members have.

C. That's why the Fed has made clear that over the long run, its goal is to move gradually towards price stability.

1. My best guess is that we *will* see some further improvement in inflation in 1994, since there's still slack in labor and product markets.

VII. To sum up, prospects for the U.S. economy over the next year or so are for moderate economic growth and some downward adjustment of inflation.

A. This isn't the boom some people might like to see.

B. But it *is* respectable growth.

1. In fact, it may *exceed* the economy's long-run potential growth rate.

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C. And it's also consistent with setting the stage for stronger, less volatile economic growth in the long term, through

   1. better prospects of reducing the federal budget deficit

   2. and progress at reducing inflation in the U.S. and in most of our major trading partners.

D. Although we have a long way to go in achieving our goals in both of these policy areas, we are making strides.

E. And it's a road we'll have to follow if we're to realize the maximum growth potential of our economy.

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