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The Global Slowdown, Deficit Reduction, and the U.S. Economy: A Monetary Policymaker's Perspective

I. It's a pleasure to be here.

A. My topic today is the U.S. economy.

1. And I think the best way to describe the current situation is that we're in a transition.

a. In other words, we're "building a bridge" in a way—from one economic stage to another.

2. And if we continue to build the bridge right, we'll find ourselves moving along a path toward an economic environment that's not only stronger, but also less prone to sharp highs and lows.

II. Let me start by focusing on the short run.

A. Three major factors dominate the U.S. economic outlook:

1. the U.S. government's fiscal policy

2. conditions in the global economy,

3. and finally, our own monetary policy.

B. In the short run,

1. the government's fiscal policy is having a *contractionary* effect on the economy, as we work to reduce the budget deficit.

2. Global economic conditions are mixed.

a. In the Pacific Rim, we're seeing strong growth, which creates demand for U.S. exports.

b. But among most of the developed countries, there's significant weakness—enough to create another major contractionary effect.

3. In the plus column is monetary policy, which has cut short-term interest rates substantially—if cautiously—in the past few years.

C. Taken altogether, this probably adds up to

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

2. small reductions in the unemployment rate,

3. and some modest reductions in inflation.

D. This short-run picture isn't what's usually considered "normal."

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.

E. 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 and monetary policies here and abroad are "building the bridge" toward a healthier economic environment in the future.

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

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 plan promises even more.

1. Therefore, spending cuts and higher taxes will weaken demand.

C. Of course, the aim of the new budget plan 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 will be available for private capital formation, which is key to long-term growth.

D. According to recent 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 a little more than $475 billion over the next five years.

E. So long as Congress and the Administration follow through, it looks like the plan *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.

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.

IV. Now let me turn to the effects of the economic performance of our trading partners, which, as I said at the beginning, has been mixed.

A. The good news is that we've had a boom in exports to developing countries in Asia and Latin America.

1. Furthermore, robust growth in U.S. exports to Asia is likely to continue.

a. Asia is now the fastest-growing region in the world.

b. One reason is that exceptionally rapid growth in China has

boosted overall growth in the region.

c. Increased trade among the economies of the region also has stimulated regional growth and helped insulate them from fluctuations in the industrial countries.

2. The potential for continued robust export growth to Latin America is less clear.

a. Their growth prospects depend importantly on whether they'll continue to enjoy easy access to the markets of the major industrial economies.

b. If they do—that is, if the Uruguay round of GATT trade negotiations and the North American Free Trade Agreement are approved—then the boost that gives Latin American economies could benefit the U.S.

V. Unfortunately, for now these positive factors are outweighed by the contractionary effects of the industrial economies.

A. For a couple of years, economic activity among these countries 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 1½ 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.

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 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.

VI. Finally we come to US monetary policy, which has worked to offset the contractionary 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 was substantial, the Fed proceeded cautiously.

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

a. If we had moved too rapidly, markets would have worried about a possible rise in inflation, which would have raised long-term interest rates and harmed the recovery.

2. Second, we've had 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.

C. And it's also consistent with building a bridge toward stronger, less volatile economic growth in the long term—through

1. better prospects of reducing the federal budget deficit

2. and continued progress in 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 progress.

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

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