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

I. Today I'd like to give you my views on the short-run and long-run outlooks for California and for the U.S. economy.

II. I'll start with California.

 A. And I won't sugarcoat it: California is in its longest and deepest recession since World War II.

 B. Southern California has felt it the most.

  1. With its large aerospace industry, L.A. has borne a disproportionate share of the defense cutbacks of recent years.

  2. The construction and real estate sectors also have taken a big hit.

   a. On the commercial side, high vacancy rates have combined with low absorption to drive rents and property values down.

   b. On the residential side, property values tumbled, and even the lowest mortgage rates in 30 years haven't managed to boost home-building activity.

  3. In fact, there's weakness in a *number* of sectors, such as manufacturing industries, retail trade, and many service sectors.

 C. All this means we'll probably see economic stagnation for a while yet.

  1. Defense cuts are expected to be almost as big in the next four years as they have been in the last five years.

  2. And the real estate situation—especially for L.A.'s downtown commercial properties—won't be resolved for at least a few more years.

 D. Now, the *long-run* outlook is not nearly so dreary.

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1. California is still a large, wealthy market for a lot of products.

2. And it's a natural for international trade with the booming Asian markets.

3. The passage of NAFTA should help expand the state's trade with Mexico,

4. and the passage of workers comp and business tax laws should improve the business climate here.

E. But the most important element of California's prosperity—for today *and* tomorrow—is its people.

1. To compete in a global economy, California's workers need to be well-trained—able to learn the skills that make them productive enough to earn a good living.

2. If we can rise to *that* challenge, California's outlook looks bright indeed.

III. Now let me give you a short-run and long-run look at the *national* economy.

A. This final quarter of 1993 is showing some strength, which is certainly good news.

1. But I think this performance is part of the same up-and-down pattern we've seen for a while now—a weak quarter or two followed by a spurt of strong growth, with the ups and downs averaging out to a moderate trend.

B. We're likely to see more of this pattern over the next year, as three major factors continue to dominate the scene. These factors are:

1. the government's fiscal policy

2. conditions in the global economy,

3. and finally, our own monetary policy.

C. 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

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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 probably adds up to

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

    b. small reductions in the unemployment rate,

    c. and some modest reductions in inflation.

D. This isn't what's usually considered "normal."

1. For example, in the two years after the trough of 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 setting the stage for a healthier economic environment in the future.

IV. 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 would be good for long-run growth.

1. The government would absorb less private saving.

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2. So more would 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 how the debate on health care shakes out.

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 significantly,[1]

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

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[1]Interest rate changes:

	SINCE 3/89	SINCE 7/90	SINCE 8/91	SINCE 2/17/93	AS OF 11/26/93
Fed Funds	-6.87	-5.17	-2.68	-0.11	2.98
3-mo. T-Bills	-5.70	-4.50	-2.21	0.21	3.12
30-yr. T-Bonds	-2.86	-2.19	-1.83	-0.80	6.31
Aaa Bonds	-2.81	-2.25	-1.76	-0.72	6.99
30-yr. Mortgs.	-3.72	-2.73	-1.93	-0.44	7.31

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budget.

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

A. For a couple of years now, economic activity among some of 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 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.

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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.

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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.

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, but it *is* respectable growth.

B. 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 continued progress in reducing inflation in the U.S.

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

D. 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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