Seattle Chamber of Commerce
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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 the Puget Sound area and for the U.S. economy.

II. I'll start with the local scene.

   A. Although this area weathered the recent recession fairly well, now that the nation's in recovery, Washington's economy is in the doldrums.

   B. Certainly a big part of the economic story here is related to the fortunes—and misfortunes—of Boeing.

      1. Many of the same factors that have constrained national employment are having an effect on Boeing—and on this area—as well, such as

         a. weakness in the domestic airline industry,

         b. global recession,

         c. productivity increases,

         d. and defense cuts.

      2. Most analysts expect the Boeing cutbacks to stall economic growth in Washington, and we've seen some of that already.

   C. On the positive side, this situation does <u>not</u> look like it's going to be a replay of the economic troubles of the early 1970s.

      1. For one thing, the Boeing cuts so far are much smaller than those of the early 1970s.

      2. And, by most accounts, Boeing is a less important part of Washington's economy than was the case in 1970.

      3. So I'd expect the next couple of years to be difficult, but not devastating, to Washington's economy.

D. Over the longer term, this region has significant strengths to draw on.

   1. For instance, many businesses in the Seattle area have strong ties to Asian markets, which are expected to be the world's fastest-growing for several years to come.

      a. And you got a chance to show off those ties at the recent APEC meeting here.

   2. In addition, the Puget Sound area offers an unusual combination of technology-oriented enterprises—from the avionics that has grown up with Boeing to the software innovations developed by firms like Microsoft.

   3. Since trade and technology are likely to be important drivers of overall economic growth during the next decade and beyond, the Puget Sound area stands to do very well 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 strength, which is certainly good news.

   1. But this performance may be 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 trend 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 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 about 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.

   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 the markets seem to share that opinion.

a. Long-term interest rates are down significantly,

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

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

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, because Asia is now the fastest growing region in the world.

2. The potential for continued robust export growth to Latin America has improved with the passage of NAFTA—and I hope it will improve more with a positive resolution of the GATT trade negotiations.

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

C. 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.

D. 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.

E. 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.

F. 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.

G. 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 <u>too</u> tight, and so, as you know, we saw more than one exchange rate crisis in Europe over the past year.

H. 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.

I. 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 <u>future</u>

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.

J. So, even though it's a hard pill to swallow, <u>most</u> 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.

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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