Economic Forum
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The Economic Outlook for 1994

I. Good afternoon. Today I want to talk to you about the economic outlook for the region and the nation.

II. Let me begin with a look at the western states--the area that makes up the Twelfth Federal Reserve District.

A. California remains in its longest and deepest recession since World War II.

1. While national employment hit its low point almost two years ago, the number of jobs in California is still falling.

2. And the trouble isn't just in the construction and defense sectors.

a. The state's economic problems have been quite broad-based.

3. Some measures of economic activity have stopped falling over the past year or so,

a. so it's possible that California's either at or near the bottom of this cycle.

4. But, with more defense cuts coming through the pipeline, continued weakness in real estate, and a weak fiscal position, I wouldn't expect to see much--if any--growth in California during the next year.

B. Washington and Hawaii also face some problems:

a. In Washington, strong growth--based largely on population growth and exports--has been dampened by the layoffs at Boeing.

b. And in Hawaii, the number of visitors has fallen with the weakening economies of Japan and California.

C. In the other six states of the District, though, activity is humming right along.

1. Alaska is holding up pretty well so far, despite reduced oil production from Prudhoe Bay and lower oil prices.

2. Arizona and Oregon are looking quite good, as in-migration is bouying most sectors of their economies.

3. And Nevada, Idaho, and Utah currently are among the nation's fastest-growing states.

III. Now let me turn to the nation as a whole.

A. If you've been watching the monthly and quarterly numbers on growth, you know the patterns have been very "up and down."

1. Take the last quarter, for example, which looks like it was an "up."

2. Most estimates are that real GDP grew at nearly a 5 percent rate.

B. But I think it's unlikely that this rate of growth will continue.

1. About 2 percentage points of the fourth quarter surge was due to a big pickup in auto production designed to replenish depleted inventories.

2. Inventories seem likely to reach more normal levels early this year. And when that happens,

a. production probably will return to the levels we saw earlier in 1993,

b. and that will slow GDP growth.

C. How should we interpret this up and down pattern?

1. Well, not so long ago, every low number for quarterly GDP growth led to rumblings that we were back on the verge of a recession.

2. But the fact is, for the last two years we've averaged annual growth of about 2½ percent a year--

a. --which is just about what our long-term trend growth seems to be.

3. So, while the shorter-term numbers may jump around, a longer-term perspective suggests that we're still on a sustainable path of moderate economic growth.

IV. I'd like to talk first about <u>why</u> we're on this moderate growth path, and then I'll conclude by explaining why I think it's a <u>good</u> path to be on.

A. I think three factors are largely responsible for propelling us along this moderate growth path.

1. First is fiscal policy.

a. The substantial cutbacks we've had--and will continue to have--make for a strong contractionary effect.

2. Second is the weak state of many of our trading partners' economies--

a. --<u>another</u> contractionary influence.

3. Third is monetary policy,

a. which is counterbalancing these contractionary forces through substantial--if measured--cuts in short-term interest rates over the past few years.

B. This combination of forces suggests that we'll see

a. real GDP growth of about 3 percent next year, compared with just over 2½ percent in 1993.

b. Along with this growth, we're likely to see small reductions in the unemployment rate.

c. And, since some slack in labor and product markets is likely to remain, I also expect a further moderate reduction in inflation in 1994.

V. Let me begin by looking at fiscal policy.

A. We've seen cutbacks at all levels of government for a while now, and Clinton's budget plan promises even more.

1. The additional cuts and higher taxes in the budget plan will weaken demand.

B. Of course, the aim of the 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.

C. Now, we still face some uncertainties--especially about what the final health care plan is going to look like and what it's going to cost.

D. But, so long as Congress and the Administration follow through, it looks like the budget plan <u>will</u> trim the deficit.

   1. And the markets seem to share that opinion.

      a. Long-term interest rates are down by ½ to ¾ percent since the budget was passed,

      b. and that will partially offset its contractionary effects.

VI. 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, and this situation certainly won't be hurt by NAFTA.

B. Unfortunately, for now this good news is outweighed by the contractionary effects of the industrial economies.

   1. For the last couple of years, economic activity among some of our major trading partners has been lackluster, or worse.

   2. In the other G-7 countries—Canada, France, Germany, Italy, the UK, and Japan—

      a. output grew on average, by only 1¾ percent in 1991, not at all in 1992, and by less than 1 percent last year.

C. 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.

D. 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.

E. 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 1993, the German economy fell into a recession.

F. Other European economies also have experienced slow growth or recession,

   1. in part because they've been affected by the German economy,

   2. and in part because, like Germany, they've been trying to control their own inflation rates.

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 there are costs.

      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.

H. 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.

VII. Finally, we come to U.S. 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 moved 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.

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

A. Now, I should add that my outlook is subject to some risk.

1. The economy accelerated sharply at the end of last year, and over 1993 a good deal of the slack in the economy was eliminated.

2. If the economy continued to grow very rapidly this year, it might overshoot its long-run productive capacity.

    a. As we all know, that would mean only one thing--higher inflation in the future,

    b. and a retreat from some of the recent progress we've made at reducing inflation.

B. That's why, in my view, a period of moderate growth would be an excellent outcome.

1. We'd have as much growth in the short-run as could be safely sustained,

2. and we'd move closer to an environment of low inflation and low budget deficits that would enhance the performance of our economy in the long run.

C. As one of the ancients said, "Moderation in all things."

1. That's a good motto for 1994.

2. We have a way to go in achieving our long-term goal of low inflation.

3. But it's important that we continue to strive for it, since it's the main contribution that monetary policy can make to maximing the growth potential of our economy.

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