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The U.S. Economic Outlook: A Monetary Policymaker's Perspective

I. Good afternoon. It's a pleasure to be here.

A. Today my topic is the national economic outlook and the implications for monetary policy.

B. As you know, recently the Fed nudged up short-term interest rates.

1. As a voting member of the Federal Open Market Committee, I was wholeheartedly in favor of raising rates because of my concerns about inflation.

C. Today, I'd like to explain why.

II. But before I get into these issues, I'd like to say a few words first about the regional outlook.

A. Oregon has been doing reasonably well for the past few years.

1. It hasn't been a star on the scale of Idaho and Utah,

2. but it *has* done much better than its neighbors to the north and south.

B. One reason for the growth is the steady inflow of population to Oregon in recent years, which has boosted the housing and retail markets.

1. Moving companies report that the number of moves *into* Oregon is far higher than the number of moves out of the state—and this pattern has existed for several years.

C. Another reason for Oregon's good fortune is that the industry sectors that have been weakest during this cycle aren't very important in this area's economy.

1. Cutbacks in military spending haven't affected Oregon nearly as much as they have California,

2. nor has the decline in the commercial aircraft market, which has been so troublesome in Washington.

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D. In addition, Oregon firms have seen tremendous growth in international trade in recent years.

1. In nominal terms, the dollar volume of exports more than doubled between 1987 and 1992, to $4.9 billion.

2. Given the recent passage of NAFTA, it's worth noting that the growth in exports to Mexico has grown *fivefold*—from less than $20 million in 1987 to more than $100 million in 1992.

E. Oregon's current strengths bode well for the next few years, when migration into the state probably will continue, and international trade is likely to become even more important.

III. Now let me turn to the national outlook. I'd like to begin with a brief look backward—on the theory that "what's past is prologue."

A. This expansion so far has been marked by two major contractionary forces.

1. I'd like to discuss these forces briefly, because although they're contractionary now, they'll lead to a healthier long-term economic outlook.

B. First, the federal government apparently has gotten serious about trimming the deficit.

1. And that has led to a *contractionary* fiscal policy with cutbacks at all levels of government.

2. Cutting the deficit will be good for long-run growth,

a. because the government would absorb less private saving,

b. so more would be available for private capital formation, which is a key to long-term growth.

C. Second, many of our major trading partners have—for various reasons—been battling down inflationary pressures, and this has been associated with slow growth or recession in those countries.

1. In fact, last year, the other G-7 countries—Canada, France, Germany, Italy, the UK, and Japan—

a. saw output grow on average, by less than 1 percent.

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2. In Japan, after years of strong expansion and phenomenal growth in asset values, in 1989 the central bank put on the brakes to head off inflation.

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

3. In Germany, the high costs of reunification begun in 1990 created inflationary pressures,

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

    b. The result is that in 1993, the German economy fell into a recession, and took much of the rest of Europe with it.

D. This weakness abroad has limited foreign demand for our products, and acted as another contractionary force in the short run—

1. —though, in the long run, it lays the groundwork for healthier economic growth.

IV. In the face of these contractionary forces, the Fed took an accommodative stance.

A. By the end of last year, we had lowered short-term interest rates substantially—

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

2. In fact, real short-term rates—that is, adjusted for inflation—were around zero levels throughout the year.

B. These low short-term rates stimulated rapid growth in the interest-sensitive sectors of the economy—consumer durables, housing, and business investment.

C. 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 lowered rates rapidly, markets would have worried about a possible rise in inflation, which would have raised long-term interest rates and harmed the recovery.

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2. Second, we've had the same concerns about inflation that Japan, Germany, and the other G-7 countries have.

3. The net result of these offsetting forces is that we've had eleven consecutive quarters of growth.

D. Now, it's important to emphasize that

1. for the last two years, average growth in the economy exceeded the rate it can sustain in the long-run—currently estimated at about 2½ percent.

2. And in the last quarter, the economy really surged, achieving a growth rate of 7½ percent.

3. As a result, a good deal of the excess capacity that built up in the 1990 recession has evaporated:

a. Both the unemployment rate and the rate of unused industrial capacity have fallen rather sharply over the past year and a half—

b. —near to levels that most economists think represent "full" utilization.

4. At the same time, inflation last year edged down only very slightly,

a. and in the case of consumer inflation averaged about 3 percent.

V. These forces will continue to play important roles in 1994.

A. Fiscal policy, of course, will remain contractionary, as the deficit-trimming continues.

B. In terms of the world economy, the picture is starting to get a *little* brighter.

1. Exports to developing countries in Asia and Latin America have been booming, and this situation certainly won't be hurt by NAFTA.

2. And we do expect the overall performance of our industrialized trading partners to improve modestly this year.

C. In February, as you know, the Fed raised short-term interest rates slightly.

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1. However, short-term real rates—that is, adjusted for inflation—remain around zero.

2. At that level, stimulus will continue to be provided to the interest-sensitive sectors of the economy.

D. Putting these factors all together,

1. the most likely outlook is that the economy *won't* keep up the very fast pace we saw at the end of 1993.

2. But it probably *will* continue to grow somewhat above the economy's long-run potential growth rate.

3. In fact, I wouldn't be surprised to see it a bit faster than the 2¾ percent *average* growth registered last year, with some further declines in the unemployment rate and in unused industrial capacity.

VI. Now let me turn to the outlook for inflation.

A. The Fed's goal—like that of many other central banks—is to get inflation down—to near zero.

B. And there are good reasons for this goal.

1. For one thing, low inflation often is associated with less uncertainty about *future* inflation, and this promotes growth in the long run in a couple of ways:

a. by fostering low long-term real interest rates,

b. and by simplifying the planning and contracting by business that's so essential to capital formation.

2. Low inflation also reduces the distortionary effects of most tax systems, so people don't need to waste time and energy on worrying about hedging inflation.

3. Finally, as we learned in the early 1980s, once inflation creeps up, it can get out of control, and it can cost many jobs to stop it.

C. But the process of reducing inflation is complicated.

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1. There are long lags from policy actions to inflation results—probably from 1½ to 2 years.

2. These lags mean that we can't wait until problems show up in the data—by then it's likely to be too late.

D. Instead, we have to anticipate problems, and pay attention to the warning signs.

E. And this is what concerns me. I think there are three warning signs for the inflation outlook. I've already mentioned them, but I think they're worth emphasizing.

1. First, slack in labor and product markets has all but evaporated.

2. Second, core consumer inflation edged down only very slightly last year.

3. Finally, short-term real interest rates have been near zero for over a year—

a. —and they still are, even though in February Fed actions in the market raised short-term rates with a ¼ percent increase in the federal funds rate.

F. The recent action is a step in the right direction.

1. But, since short-term real rates still are quite low, it's unlikely that that one step is going to be enough.

a. The last time short-term real rates stayed at low levels for a long period of time was in the 1970s, just before the run-up in inflation in the late 70s and early 80s.

b. Although the current situation isn't nearly as dire as that one was, we don't want to risk even a small part of that kind of problem again.

G. We *have* made progress in achieving our long-term goal of low inflation.

1. But we still have a way to go.

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

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